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INCREASING PRODUCTIVITY AND ADMINISTRABILITY OF THE TAX CODE

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BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

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INCREASING PRODUCTIVITY AND ADMINISTRABILITY OF THE TAX CODE

MONDAY, SEPTEMBER 17, 1984

U.S. SENATE,
SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE,
COMMITTEE ON FINANCE,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:35 a.m. in room SD-215, Dirksen Senate Office Building, the Honorable Charles E. Grassley (chairman) presiding.

Present: Senator Grassley.

[The press release announcing the hearing and Senator Grassley's opening statement follows:]

FINANCE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE SETS FINAL HEARING OF SERIES RELATING THE TAX CODE'S INFLUENCES ON PRODUCTIVITY AND ECONOMIC GROWTH

Senator Charles E. Grassley (R., Iowa), Chairman of the Finance Subcommittee on Oversight of the Internal Revenue Service, announced today that the Subcommittee will hold the last hearing of a series of hearings which began last spring on relating the tax code's influences to productivity and economic growth.

The hearing will be held on Monday, September 17, 1984 at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

"Past hearings in this series have covered the agriculture and small business segments of the economy, as well as a general overview of the economic scene. The purpose has been to understand the impact of the Federal tax system on individual decisions in the economy: to examine microeconomic effects as the basis for improving the Federal tax system," Senator Grassley stated.

Senator Grassley noted that "prior hearings brought a wider range of testimony than was originally expected. We did get many new ideas about the tax code and productivity. However, we came to realize that most witnesses were interested in basic fundamental tax reform.

"In this hearing we want to focus on what systemic tax reforms can be made to increase productivity and administrability of the tax code," Senator Grassley added.

REMARKS OF SENATOR CHARLES E. GRASSLEY, CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

Today marks a milestone in the development of the tax system in this Nation. It may seem like a small milestone, but it is significant nonetheless. For today, we conclude the first Senate hearings that have inquired into the most important aspect of the tax system: the impact of federal taxation on the operation of business, individual activity, and the economy as a whole.

The Congress has always been interested in the most obvious effects of taxation: how much revenue will the tax system raise? How will the tax system stimulate this or that activity? How will it help or hurt farmers, small businesses, basic industries, and the home owner. These are important questions, and the Congress has been flat-out right in asking these questions over the years.

But there is more to it than that. The really basic questions have little to do with how the tax system affects this or that group, or how it stimulates this or that activity. The really basic questions have to do with the impact of the tax system on the most far-reaching decisions that top corporate managers make. The really important questions have to do with the way in which the current tax system imposes tax burdens on one group and not another. The really basic questions have to do with how the tax system induces business managers and individuals to decide on one course of conduct, because it has tax advantages, rather than another course of conduct, which might be more economically sensible.

Last spring, this Subcommittee began these hearings with an examination of the microeconomic effects of the current Net Income Tax system. We thought that the microeconomic approach would reveal problems and dysfunctions that the Congress could correct through legislation. We were right, but we got much more than we bargained for. We learned about the microeconomic problems, to be sure. But we learned much more. We learned that the problems with the current Net Income Tax system are much more serious than we realized. The problems are serious in several areas: the current system is perceived as unfair, inequitable, inefficient, and biased toward certain kinds of economic activity. These complaints were raised by a wide range of witnesses: highly respected economists; small business representatives; top managers and representatives of basic industries, service industries, and investment industries; and farmers.

They all had the same message: reform. The witnesses spoke again and again of reform. Basic, fundamental, reform. I would like to call it "systemic reform," because what these witnesses called for it more than a fix-it approach. We like to say, "If it ain't broke, don't fix it." Well, the message from the witnesses before this Subcommittee is, "It is broke, so do fix it."

I am very pleased today to welcome a panel of distinguished witnesses who will help the Subcommittee in the final phase of this inquiry. In this final phase, we want to step back from the details of the current tax system and look at long-range consequences, and long-term solutions. These hearings, so far, have gravitated upwards toward a full-scale indictment of the Net Income Tax. Where does that leave us today? What have we wrought, as a people, in this current Net Income Tax system? Where should we go from here?

Senator GRASSLEY. I would like to convene this hearing of the subcommittee I chair on the Oversight of the Internal Revenue Service and welcome the public at large, witnesses specifically, the staff, everybody who has been so helpful in this, the last of a series of hearings that we have held on the development of the tax system and how it impacts upon productivity and the economy generally in this country. Today we conclude the first Senate set of hearings that have inquired into this most important aspect of the tax system from this standpoint, the impact of the Federal taxation on the operation of business, individual activity, and how those affect the development of the economy as a whole.

The Congress has always been interested in the most obvious effects of taxation, how much revenue will the tax system raise, or the question of how will the tax system stimulate this or that activity, or how will the tax system help or hurt farmers or small businesses or basic industries or the homeowners, and to some extent we have even looked into those things in this set of hearing, but all leading to the very important questions that Congress ought to be asking over the years. These are very important questions, but there is more to the questions that ought to be asked than just those very basic ones, and those really basic questions that we have to ask have little to do with how the tax system affects this or that group or how it stimulates this or that activity. The really basic questions have to do with the impact of the tax system on the most far-reaching decisions that top corporate managers and anybody investing in this country have to make.

The really important questions have to do with the way in which the tax system imposes burdens on one group and not another, the really basic questions have to do with how the tax system induces business managers and individuals to decide on one course of conduct or another because it has certain tax advantages rather than on another course of conduct that might be more economically sensible, the basic issue, then, of between making those decisions based upon the tax consequences of the investment or expenditure as opposed to what the real economic aspects of those decisions are. And I guess we start with the supposition that the latter ought to be the main basis for investment and expenditure by business in this country, and also basic decisions of the consumer as well.

If you remember, last spring the subcommittee began hearings with an examination of the microeconomic effects of the current net income tax system. We thought that the microeconomic approach would reveal problems and disfunctions that the Congress could correct through legislation. We were right, but we got much more in those series of hearings than we bargained for. We learned about the microeconomic problems to be sure, but we learned much more.

We learned that the problems of the current net income tax system are much more serious than realized. The problems are serious in several areas:

The current system is perceived as unfair, inequitable, inefficient, and biased toward certain kinds of economic activity. These complaints were raised by a wide range of witnesses that we had throughout the spring and summer—highly respected economists, small business representatives, top managers and representatives of basic industries, also the service industries, the investment business, and even farmers.

These various groups all came to somewhat the same conclusions, and the message that they gave us was that reform was dramatically needed. The witnesses spoke again and again of the word "reform," basic fundamental reform.

I would like to call this call for fundamental reform as systemic reform, because what these witnesses called for was more than a quick-fix approach. And you know the old saying, "If it ain't broke, don't fix it"; well, the message from the witnesses before this subcommittee through the spring and summer has basically been, "It is broke, so do fix it."

I am very pleased today to welcome a panel of distinguished witnesses—three panels in number—who will help the subcommittee in the final phase of this inquiry. In this final phase we want to step back from the details of the current tax system and look at the long-range consequences and the long-term solutions.

These hearings, so far, have gravitated upward toward a full scale indictment of the net income tax. So then, today we ask, "Where does that leave us? What have we wrought as a people in this current net income tax system, and where should we go from here? That is the basic issue.

Of course, as we even look at this current election campaign between the two candidates for President and many of the candidates of both Houses of the Congress, this issue is being addressed right now. There is some indication from the political talk going on this

fall that we might prognosticate that there will be a major overhaul in the coming spring.

I suppose we are all pessimistic about that, because we have supposed that for a long period of time, going back even to the 1976 election, and not a whole lot has materialized. In fact, if you look at the size of the Tax Code, I suppose if you measure it just by volume you can say the situation is getting worse instead of better.

But, regardless, we now begin this last series of hearings, hopefully setting a record as we go into deliberations in the Senate Finance Committee, and hopefully in the House Ways and Means Committee, that these issues will be looked at thoroughly so that there is a major overhaul of the tax system next year—as an end in itself, but also partly as an answer to the general question that is so basic right now in this political season, "Will there, or will there not, be a tax increase? And if there is going to be one, when does it come in the process of determining a budget deficit? Before expenditure reductions, or after expenditure reductions, or simultaneous with that discussion?"

Now, as I call the first panel, I am sorry to announce that one of our very fine witnesses, Lew Lehrman, who is chairman of the Citizens for America and a business person in New York and also a Republican and conservative political leader in this country, is not going to be able to be with us because, as my staff said, he is "stuck" in Philadelphia. I guess transportation was a major problem. So we only have two people, then, on our first panel.

Paul Huard is currently vice president for taxes and fiscal policy, National Association of Manufacturers. He is a graduate of the Boston College Law School, Master of Law—Taxation—at Georgetown University, and he has served as an enforcement attorney for the SEC.

We also have on the same panel—and I will call Paul first—second, Jack Walter. I will ask each of you to testify and will have questions of you as a panel. Jack Walter is currently president of the National Academy of Public Administration, was first a Senate-confirmed appointee to the Director of Office of Government Ethics under President Carter and was retained in that position by President Reagan, has been a member of the Florida State government's cabinet and a graduate of Amherst College and Yale University Law School.

Thank you both very much. I guess maybe I ought to make the usual administrative announcements before you start your testimony, that the record will stay open for about 10 or at the most 15 days for any additions or corrections that any of the panel have to it. Also, if there is anybody who has a short statement, who was not invited to testify on this issue, that would like to have their testimony considered for the committee's consideration, we would be glad to receive that as well.

I guess that's it. Would you like to start out, Paul?

STATEMENT BY PAUL R. HUARD, VICE PRESIDENT, TAXATION AND FISCAL POLICY DEPARTMENT, NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, DC

Mr. HUARD. Thank you, Senator.

We have a prepared statement on behalf of the association which I would like to submit for the record. I will try to summarize my comments therein. I think it may be more helpful to have a brief summary and then an opportunity for questions.

Let me turn first to the issue of productivity. I think the tax policy, while certainly not the only factor affecting productivity, nevertheless represents one major means of improving productivity by stimulating a greater shift of resources to items such as capital expenditures and research and development.

Furthermore, we find that specifically targeted tax incentives are more effective in stimulating productivity in the economy than more general measures such as overall rate reduction.

On the specific issue of productivity, therefore, we would support changes in the existing law which would have the effect of specifically targeting the incentive effect of the law in the areas of productivity with particular regard to capital expenditures and research and development.

Specifically, we would be very supportive of restoration of the Accelerated Cost Recovery System to its original configuration as passed in 1981. As I am sure you may recall in 1982 and again in 1984 there were rather significant dilutions to the Accelerated Cost Recovery System made in the tax bills that were enacted in those years.

In the area of research and development, we would support making permanent and improving the existing R&D tax credit, which as you know will expire at the end of next year. Likewise, we would support further extension of the moratorium on regulation 861, which has to do with the allocation of R&D expense. It is a somewhat esoteric provision, but the net effect of the moratorium is to improve the situation in terms of R&D expenditures for domestic companies.

Let me turn now to the broader issue of systemic reform to make the system generally more efficient, more administerable, and more stimulative of economic growth. In reaching an understanding of this issue it is helpful to review the three major generic approaches to achieving so-called reform, and maybe we should put quote marks around reform.

The first is the nickel and dime or cats and dogs approach, which I'm sure you as a member of this committee are quite familiar with. It is the approach we used in 1982 and is the approach that we used again in 1984, where you make literally hundreds—200 to 300—discrete, relatively minor changes in the tax code, where nobody suffers any major disaster but everybody loses a little, and everybody's taxes go up a little. I guess Senator Dole, in particular, has discovered that this is a technique that enables him to get a bill out of the committee.

The problem with that approach, of course, is that it doesn't do anything for simplifying the system. What you do is you add thousands of pages to what already is an over lengthy and over complicated law, and I think sooner or later this particular technique is going to be subject to the law of diminishing returns. I am not too sure how many more acts like TEFRA or the 1984 act you can have before you run out of nickels and dimes. So we frankly are not very

supportive of any future attempts to reform the system through that kind of technique.

The second generic approach is a major overhaul—which, more bluntly, is the so-called meat-axe approach, and in this regard there are numerous proposals before the Congress which I am sure will be introduced in the next Congress. Among these are the Bradley-Gephart bill, the Kemp-Kasten bill.

The trouble with all of these is that they involve repealing scores—30, 40, 50, 60—deductions, credits and exclusions currently in the law. In a nutshell, I think they upset too many economic applecarts in which economic and investment planning, and compensation planning decision, have been made. They are too ambitious, and I don't think they are politically do-able.

The last approach is to turn to something entirely new, which we have concluded is probably the best technique, and that is a transactions-based tax—either something in the nature of a value-added tax or a national sales tax, with the revenue being used essentially for two purposes. Part of the revenue we believe should be used straight out to just reduce deficits. The remaining part should be used to lower income taxes. You are going to have to make some adjustments to handle the regressivity issues at the lower end of the income tax scale, and I think the rest of the revenue can be used either for specifically targeted capital formation incentives or things like reducing the double taxation of corporate dividends, which as you know is a considerable disincentive to equity-type investment.

The advantages I think of a transactions-based type of tax can be summarized as follows:

Contrary to popular mythology, a properly designed tax with a single rate and very few exemptions is not an administrative nightmare for business or anybody else—it would be relatively easy to administer and collect.

Two, I think it is more efficient. If you tax a broad range of goods and services, you are going to reach into the underground economy; that unreported income which no type of income tax that I am aware of is really going to drag into the system will be taxed by a consumption tax when it is spent in the above-ground economy.

Finally, I think you will promote economic growth. I think this will happen in a number of ways: No. 1, I think you will find that reducing the deficit will be helpful to economic growth; No. 2, I think using part of the revenues to lower income taxes will be stimulative of economic growth; and, finally, No. 3, I think by enacting this type of tax you will repair a lot of the difficulty we have had in being competitive in international markets.

We now get 92 percent of our tax revenues from a combination of corporate and individual income taxes and payroll taxes. When businessmen pay these taxes, they are built into the price of the products they manufacture. When you try to export those products, you can't rebate that tax component. We have signed the General Agreement on Tariffs and Trade and we are obligated to live by those agreements. And we don't have what amounts to a rebatable tax. A transactions-based tax would be a rebatable tax. When we export products, we could take that tax component out of the price

of the products. I think it would go a long way towards making us more competitive in international markets. It would bring us more into line with the tax systems of all of our major trading partners who derive a much larger component of their total Government revenue from consumption taxation than we do, and correspondingly they derive a much lower component of their revenues from income taxation.

That summarizes the points in my testimony, Mr. Chairman. Thank you.

Senator GRASSLEY. Thank you, Paul.

Mr. Walter?

[Mr. Huard's prepared statement follows:]

STATEMENT OF

PAUL R. HUARD

ON BEHALF OF THE

NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

SENATE FINANCE COMMITTEE

ON TAX REFORM, ECONOMIC GROWTH AND PRODUCTIVITY

SEPTEMBER 17, 1984

I am Paul Huard, vice president for taxation and fiscal policy of the National Association of Manufacturers (NAM). The National Association of Manufacturers is a voluntary business association of over 13,000 corporations, large and small, located in every state. Members range in size from the very large to over 9,000 smaller manufacturing firms, each with an employee base of less than 500. NAM member companies employ 85 percent of all workers in manufacturing and produce over 80 percent of the nation's manufactured goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council. On behalf of our members, I am pleased to be able to present our views on tax reform, economic growth and productivity.

I. SUMMARY

The first part of this statement examines the major causes of the productivity decline, both in the United States and overseas. The second part examines the evidence on tax policy as a determinant of economic outcomes. The final section presents a series of recommendations on tax policy options.

During the period from 1973 onward, productivity in the United States fell below its long term postwar growth rate. The causes of the global productivity slowdown had to do primarily with the energy shocks, i.e., the successive increases in OPEC oil prices, in conjunction with the restrictive reaction of macroeconomic policy, which substantially slowed the growth rate of the world economy. In the United States, the subnormal productivity performance was exacerbated by other factors such as changes in the demographic mix of the labor force, changes in the sectoral mix of output, and regulatory drag.

The deepest phase of the productivity decline is now over. The outlook is for a better aggregate performance in productivity in 1984-85 primarily because of the upturn in the business cycle. However, the longer term productivity performance will also improve for several reasons. The decline in energy prices since 1981 will be a critical factor in raising cyclically-adjusted productivity growth. The maturation of the workforce and the resulting improvement in skill levels will also make a positive contribution to productivity growth. Finally, although regulatory reform has not progressed as far as would be desirable, there has

been a substantial slowdown in the growth of regulatory costs.

Productivity performance depends a great deal on the stability of the business cycle, not only because of the impact of year-to-year growth rates on productivity, but also because prolonged recessions lead to contractions in capital investment and thus lower the trend rate of productivity growth. Therefore, the overall posture of monetary, fiscal and tax policy should aim at a stable growth path for the economy. In this respect, tax policy must be considered in conjunction with the overall mix of macroeconomic policy. Tax policy is more likely to enhance productivity when it is accompanied by monetary and spending policies that work in favor of stabilizing the business cycle.

The productivity slowdown was not caused primarily by increased tax drag during the 1970s. Nevertheless, tax policy represents one major means of improving productivity by shifting the sectoral allocation of resources in favor of greater capital spending and R&D. The existing research on taxes as a determinant of macroeconomic outcomes points in the direction of the following conclusions:

Tax policy is also more likely to raise productivity when it consists of measures that will increase factor inputs to production such as capital formation. In this respect, specific tax measures designed to improve business liquidity, lower the user cost of capital and increase savings will have a stronger impact on productivity than more general tax reforms which do not address these areas.

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The ACRS depreciation reform passed under ERTA has had a favorable impact on business liquidity and capital formation. Econometric studies demonstrate that if ERTA had not been passed, business liquidity would have been lower and the contraction in capital investment would have been more acute during the 1981-82 recession than what actually took place. Once the economy passed its cyclic trough, ACRS added positively to the cyclical recovery in capital formation. In this respect, further acceleration of depreciation schedules, for instance through first year expensing for equipment, should be considered in order to further increase capital formation.

Productivity and long term economic growth can also be raised through increased R&D. Tax measures to stimulate further R&D should therefore be adopted. These include making permanent the incremental R&D tax credit enacted as part of ERTA, and making permanent the moratorium on Section 1.861-8 of the Treasury regulations governing allocation of research expenditures.

To the degree that Congress undertakes any systematic reform of the tax system, in NAM's view, this should consist of a shift towards consumption taxes rather than any of the existing "flat tax" proposals. Further, consumption taxes at this time should be designed primarily in order to reduce the federal deficit. However, there is some merit to structural reforms aimed at shifting the tax burden from income to consumption.

Greater taxation of consumption would provide the long term benefit of increasing savings, thereby raising aggregate liquidity and reducing interest rates. At the same time, however, it should

be noted that this would be primarily a long-run effect, and that the short-run impact would be less favorable. The proximate result of high consumption taxes would be a drop in effective demand, which would be accentuated by the rise in the price level associated with the addition of the tax to prices. However, the weaker economy would lead to cyclical decreases in interest rates. The resulting decline in the user cost of capital would lead to greater investment and indirectly to higher productivity growth via the capital-labor ratio. In the long term, therefore, the benefits of shifting the tax base toward consumption rather than income would outweigh the short-term costs.

II. THE PRODUCTIVITY ISSUE

Table 1 gives the growth rate of productivity in the non-farm business sector for the period 1950-83.

Since the mid-1970s, there is evidence of a marked deterioration in the rate of productivity growth both in the United States and throughout the industrial countries. Productivity growth rates initially slackened in late 1973, and declined sharply in 1974. Thereafter, productivity growth underwent a cyclical recovery in 1975-78, although it did not attain the growth rates witnessed during prior expansionary periods. In the United States, productivity growth was well below trend during the later stages of the 1975-79 recovery. Beginning in 1979, productivity growth again became negative in the United States. However, 1983 has witnessed a normal cyclical recovery in

productivity growth, comparable to the earlier recovery in 1976. Whether this recovery will be transitory, or whether productivity growth will return to its postwar trend during the upcoming business cycle will depend critically on the economic environment. Changes in tax policy can contribute to a better performance.

The causes of the productivity decline have been documented in numerous econometric studies. On a year-to-year basis, lower productivity growth reflects the aggravated downturns in the international business cycle, manifested in the depth of the worldwide recessions of 1974-75 and 1980-82. On a cyclically-adjusted basis, the longer-term productivity decline reflects the effects of the successive energy shocks of the 1970s and other factors such as changes in the demographic composition of the labor force, regulatory drag, and changes in the sectoral mix of output.[1]

Cyclical Factors. In the United States, productivity underwent a mild slowdown during the late 1960s, notwithstanding continuous economic expansion at this time, due in part to high rates of labor utilization. Partly for this reason, the productivity decline during the 1969-70 recession was more acute than during prior recessionary periods in the late 1950s, despite the fact that the downturns were deeper. However, the sharpest cyclical fall in productivity took place during the recession of 1974-75, which was distinctive both in its extreme depth and its worldwide character. The first OPEC crisis took place at the final stages of a worldwide reflationary boom, when the global

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economy was already substantially overheated. The resulting acceleration in inflation, further aggravated in the United States by the removal of wage-price controls, induced a sharply restrictive monetary-fiscal reaction at a time when inventories were substantially overbuilt. The ensuing simultaneous fall in demand throughout the industrial countries caused the recessionary trend to be transferred across national boundaries through the channel of diminished trade flows. This combination of events effectively made the recession worldwide. Econometric analysis of the world productivity slowdown at this time confirms that throughout the industrial countries this phenomenon is explained largely by the combination of the energy shock and the contraction in output associated with the restrictive macroeconomic reaction. To a substantial degree, the same process was repeated following the second OPEC shock in 1979-80. This time, the world economy was moving less rapidly, while the feed-through of energy prices into domestic inflation rates was more gradual, producing a slower decline into recession. In part because of the slower pace of the contraction, labor markets equilibrated more rapidly relative to the fall in demand, with the result that the recession was associated with smaller decreases in productivity and greater increases in unemployment than in 1974-75. By comparison, during the recession of the mid-1970s, the speed of decline was so rapid that employment fell only with substantial lags, leading to a very sharp initial decline in the output-labor ratio. However, the recessionary period in 1980-82 was considerably longer than that of 1974-75, both because of the prolongation of monetary restraint

in the United States, and because the appreciation of the dollar impelled the other industrial countries to refrain from countercyclical policies in order to support their exchange rates. The result was that the cyclical decline in productivity at this time lasted for a period of roughly three years.

The contribution of cyclical factors to the slowdown in productivity during the intervening recovery in 1975-79 is less clear, but underutilization of capacity appears to have played some role in other countries. The recovery of 1975-79 was unusually slow in all the industrial countries except the United States, where the looser stance of monetary policy enabled restoration of normal postwar growth rates in real GNP and a full recovery in capacity utilization. Nevertheless, while the American economy had converged to full capacity by 1978, Canada, Japan, and Western Europe continued to experience substantial slack. The role of underutilization of capacity as an explanation for slower productivity growth has been corroborated econometrically for Canada and Western Europe. However, because of the strength of the recovery in the United States, this explanation is largely irrelevant here. As a result, an explanation of this development requires recourse to non-cyclical factors.

Non Cyclical Factors. Of the major non-cyclic components of the productivity decline, the most important has been the change in relative energy prices. The rise in oil costs is estimated to have accounted for one-third of the cyclically-adjusted

productivity slowdown in the United States since 1973. In addition to their direct impact on factor inputs of energy, the OPEC shocks are estimated to have had a secondary depressing effect on productivity through the capital-labor ratio and the output mix. The OPEC shocks raised the relative cost of capital inputs because of the complementarity of capital and energy; at the same time, they engendered shifts in the sectoral composition of output from energy-intensive manufacturing industries, which typically exhibit high productivity growth, to non-energy-intensive services where productivity growth rates tend to be lower.

Finally, several other factors account for the residual in the productivity decline. The demographic composition of the workforce appears to have slowed productivity growth consistently over the postwar period, although interestingly enough this factor was probably more important prior to the 1970s. Regulatory drag, however, has been estimated to be a relatively important factor, although the magnitudes have varied depending on the methodology used. The role of R&D in accounting for the productivity slowdown is somewhat ambiguous. However, since R&D constitutes a major factor input to production, measures designed to enhance R&D spending can be used in order to raise productivity over the upcoming business cycle.

The Current Outlook. The current outlook for productivity is for relatively normal cyclical behavior over the recovery. In 1983, non-farm productivity grew by 3.1%, essentially comparable

to the recovery in productivity growth that took place in 1976. It remains to be seen, however, whether productivity will continue to rise at this rate, or whether it will undergo a consistent deterioration over the business cycle as it did during the late 1970s. Factors working in favor of higher productivity growth at the present time include lower energy prices and the expected cyclical rise in capital investment; despite the high user cost of capital, the contraction in the capital stock since 1980 implies the need for substantial retooling. However, in the long term, the user cost of capital and a slowdown in wage increases associated with slack in labor markets work against major increases in the capital-labor ratio.

III. THE EFFECTS OF TAXES ON ECONOMIC ACTIVITY

The relationship between tax policy and productivity must be viewed as essentially indirect and long term in nature. Nevertheless, tax changes constitute one of the major policy areas that can be used to raise productivity growth inasmuch as tax codes can be used to influence inputs of capital through such mechanisms as depreciation reform. While there is general agreement in economic theory that selective changes in the tax laws can exert a statistically significant impact on capital formation, there is, however, less consensus as to the magnitudes involved. Some discussion of the evidence on the relationships between tax policy and key economic indicators is therefore in order.

Business Investment. There is considerable evidence that the tax system in the United States has depressed corporate profitability and business investment, particularly during the more inflationary environment that has prevailed since the late 1960s. There were two major components of this process, the overstatement of inventory profits and the understatement of depreciation costs under the ADR system. Any number of studies have demonstrated that a substantial decline in the real rate of return on corporate equity and a rise in the real user cost of capital took place during the 1970s.[2] This depressed capital formation both because investors shifted their asset portfolios away from corporate equity into interest-bearing instruments and because corporations were forced to incur higher debt-equity ratios in order to finance capital expansion. When excess taxation of business income is entered as a determinant of capital formation in full scale macroeconomic models the results show a statistically significant impact on investment.[3]

The result is that business tax cuts can be expected to significantly raise the long term growth of the capital stock. Of the possible corporate tax measures to enhance capital formation, NAM considers retention of the Accelerated Cost Recovery System (ACRS) passed in 1981 as part of the ERTA package to be the most important priority at this time. The liberalization of depreciation schedules directly raised corporate liquidity and permits greater capital spending through retained earnings. The depreciation reform also lowered the effective user cost of

capital, and shifted relative prices in favor of greater factor inputs of capital. The need to preserve ACRS incentives is underlined by the fact that depreciation schedules were subsequently lengthened under TEFRA in 1982.

The Effects of ERTA. With somewhat less than three years elapsing since the passage of ERTA in 1981, the evidence on the effects of these tax cuts on the economy is at the present time only partial. Nevertheless, econometric tests using large scale macroeconomic models have pointed to a generally favorable impact.

The simulations suggest that ERTA did in fact exert a significant positive effect on the economy. With 1980 tax laws in place and assuming no countervailing changes in monetary policy, the contraction in consumption, investment and aggregate economic activity resulting from the 1981-82 recession would have been considerably more acute, and the gains associated with the recovery would have been weaker. Over a 1983-85 forecast horizon, the elimination of ERTA with no compensating loosening of monetary policy causes real GNP to be lower by magnitudes of up to 1.2 percentage points. The losses in business fixed investment that would have taken place without ERTA are even greater. In sum, the business provisions of ERTA substantially reduced the cyclical losses in output and investment associated with the 1981-82 recession, and will contribute to raising the cyclical gains during the upcoming recovery.

IV. POLICY RECOMMENDATIONS

In considering fundamental reform of the tax system, it should be borne in mind at the outset that historically the tax system has tended to favor consumption at the expense of savings and investment. This is evident from the fact that income is taxed when it is earned, and then if it is saved the income on such income is also taxed. Another glaring example of the system's anti-investment bias is the double taxation of corporate earnings paid out as dividends. In such cases, the combined income taxes paid by the company and its shareholders on the company's earnings can rise to as much as 73 percent at the federal level alone. Moreover, some 55% of federal revenue is derived from income taxes, which is a much higher ratio than in the other industrial countries.

While this bias toward rewarding consumption at the expense of savings and investment was in part redressed by the capital formation incentives contained in ERTA these incentives have already been substantially diluted under TEFRA and, to a somewhat lesser extent, by the Tax Reform Act of 1984. NAM believes it is critical that we preserve important capital formation provisions such as the Accelerated Cost Recovery System (ACRS) and the Investment Tax Credit (ITC). These incentives--which should receive a large share of the credit for the strength of the current recovery in capital formation--are necessary to enable major corporations to make productivity-enhancing investments.

Bearing these considerations in mind, there are clear differences in the implications of the major proposals for tax reform now under consideration. Three major types of tax reform have been proposed:

1. "Reform" of the system through numerous adjustments to the existing basic framework. This approach would merely repeat the technique used in TEFRA and the Tax Reform Act of 1984, where literally hundreds of changes modifying existing law were adopted.

2. Major overhaul of the existing tax system, involving a substantial broadening of the taxable income base together with a lowering of marginal tax rates. The base broadening could be achieved by either eliminating many existing deductions and credits, or expanding the definition of gross income to include items presently excluded, or both.

3. Enactment of a tax which is an "add-on" to the existing system and thus leaves that system intact. Surtaxes levied on the present income tax would be one approach; another would be imposition of a totally new tax such as a VAT or a national retail sales tax.

The first approach listed is clearly the least desirable. Legislation such as TEFRA and the 1984 Tax Reform Act merely add further complications to a statute already overburdened with complexity. They are not based upon any discernible principles of consistency in tax policy. Rather, their primary motivation--and in our view quite possibly their sole justification--is purely and simply the raising of revenue to reduce deficits. At best, such bills are patchwork repair jobs; at their worst, they are

near-classic examples of political expediency. More significantly, we may now have reached the stage where the "tinkering" approach has been so overused that it will produce only diminishing returns.

Attempting a major overhaul of the existing system does have a great deal of appeal, particularly from the standpoint of simplicity. Any such overhaul, however, is likely to face enormous obstacles. In particular, efforts to broaden the taxable income base can be expected to give rise to substantial resistance on numerous fronts. All of the comprehensive base-broadening plans we have examined would require repeal of literally scores of exclusions, deductions and credits presently in the law. Each such provision was adopted for policy reasons considered meritorious by the Congress and many of these have been in the law for decades. Furthermore, --and we wish to place considerable emphasis on this point--flat tax proposals on other full scale reforms of the tax code do not have any beneficial impacts on productivity or capital formation. The notion that a flattening of personal tax rates will raise capital investment and productivity has no basis whatsoever in economic theory. Instead, raising productivity requires that the tax system contain specific incentives for capital formation and R&D.

In light of the foregoing considerations, the final generic approach that we mentioned--an "add-on" to the existing system--seems to have some promising features. An "add-on" tax that is simple and fair could be enacted in a much shorter time frame and with considerably less attendant controversy than could any major

overhaul or restructuring proposal. Of the two "add-on" proposals most often mentioned--income tax surtaxes and transaction-based consumption taxes--it is clear that the latter are much to be preferred to the former.

The various factors recited above, among others, have led NAM to conclude that a consumption-based tax would offer the best balance between the need to retain incentives for savings and investment and any perceived need for additional federal revenues. Revenues from such a tax could be used at least in part to replace revenues from the existing income tax system, thereby reducing its bias against savings and investment.

Design of a Consumption-Based Tax NAM believes that a consumption-based tax should include the following design features:

1. Simplicity. The tax should be simple to understand and to administer. This factor clearly points to a transaction-based consumption tax, e.g., one imposed on an ad valorem basis when a taxable product or service changes hands.

2. Breadth. Obviously, the broader the base of the tax, the lower the rate that will be required to raise a specified amount of revenue. This is perhaps the most critical factor to be evaluated in determining the scope of any transaction-based tax. We believe the fairest and least disruptive approach is to use the lowest possible rate on the broadest possible base. What this means, of course, is inclusion of services as taxable items and taxation on the basis of full value (i.e., including retail markup

in the tax base). If the service sector is substantially omitted, the burden of the tax will tend to fall entirely on manufactured goods and a much higher rate will be required. A similar result will occur if the retail markup is omitted from the taxable base. Another advantage to using the broadest possible base is that it will maximize the federal government's recapture of presently-lost tax revenues from the so-called "underground economy." This will occur when such unreported income is spent in the "above ground economy."

3. Fairness. In the case of transaction-based consumption taxes, an often-voiced concern is the potentially regressive impact of such taxes on lower income individuals. We believe, however, that any such impact can either be eliminated or at least satisfactorily mitigated by (a) low rating, zero rating or exempting certain necessities such as food and medicines, (b) providing income tax credits or increased personal exemptions and zero bracket amounts for such individuals, or (c) some combination of these techniques.

4. Other Tax Reforms. Further, we wish to reemphasize our commitment to preserving existing tax incentives for R&D and capital formation.

Capital Formation. The most critical element of any tax policy aimed at enhancing productivity is to stimulate additional capital formation. The ACRS depreciation reform enacted in 1981 went quite far in redressing the overstatement of corporate tax liabilities resulting from ADR, but was subsequently diluted by

the passage of TEFRA in 1982. Moreover, ACRS did not represent an improvement in depreciation schedules over ADR for certain high technology industries with short-lived assets. At the very least, the existing ACRS depreciation laws should be retained. At some future time, Congress should give serious consideration to further acceleration of depreciation schedules, for instance through the enactment of first year expensing for capital equipment.

R&D Improvement. Notwithstanding the finding that R&D was not closely related to the productivity slowdown, productivity could be enhanced in the long term by greater R&D. Several measures can be taken to improve R&D, including; 1) making permanent the 25% tax credit on incremental R&D expenditures enacted under ERTA, which is currently scheduled to expire at the end of 1985; 2) making permanent the moratorium on Section 1.861-8 of the Treasury Regulations governing allocation of R&D expenditures. Other measures aimed at stimulating R&D such as patent term restoration should also be considered.

I hope that the foregoing suggestions are of assistance to the Committee in its deliberations on this important matter. I will be pleased at this time to address any questions you may have.

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TABLE 1

PRODUCTIVITY GROWTH, NON-FARM BUSINESS SECTOR (1950-84)

1950	6.0	1962	3.6	1974	-2.5
1951	1.7	1963	3.2	1975	2.0
1952	2.3	1964	3.9	1976	3.2
1953	1.7	1965	3.1	1977	2.2
1954	1.4	1966	2.5	1978	0.6
1955	3.9	1967	1.9	1979	-1.5
1956	0.3	1968	3.3	1980	-0.7
1957	1.7	1969	-0.3	1981	1.9
1958	2.4	1970	0.3	1982	-0.1
1959	3.4	1971	3.3	1983	3.1
1960	0.8	1972	3.7		
1961	2.9	1973	2.4		

Source: Bureau of Labor Statistics

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NOTES

1 The conclusions with respect to productivity are based primarily on the following studies. Michael Bruno, "World Shocks, Macroeconomic Response, and the Productivity Puzzle," National Bureau of Economic Research working paper #942, 1982. Gregory Christainsen and Robert Haveman, "Public Regulations and the Slowdown in Productivity Growth," in American Economic Review, vol. 71 (1981), pp. 320-325. Edward Denison, Accounting for Slower Economic Growth, Washington, D.C., Brookings Institution, 1978. Otto Eckstein and Robert Tannenwald, "Productivity and Capital Formation," in Data Resources Review of the U.S. Economy. February 1981. Robert J. Gordon, "The 'End of Expansion' Phenomenon in short Run Productivity Behavior," in Brookings Papers on Economic Activity, 1979a, pp. 447-461. Robert J. Gordon, "Monetary Policy and the 1979 Supply Shock," National Bureau of Economic Research working paper #419, 1979b. Zvi Griliches, "R&D and the Productivity Slowdown," in American Economic Review, vol. 70 (1980), pp. 343-348. John F. Helliwell, "Stagflation and the Productivity Decline in Canada, 1974-1982," National Bureau of Economic Research working paper #1185, 1983. Assar Lindbeck, "The Recent Slowdown in Productivity Growth," in Economic Journal, vol. 93 (1983), pp. 13-34. Robin Siegel, "Why has Productivity Slowed Down?" in Data Resources Review of the U.S. Economy, May 1979.

2 Alan J. Auerbach, "Inflation and the Tax Treatment of Firm Behavior," in American Economic Review, vol. 71 (1981), pp. 419-423. Michael Boskin, "Taxation, Saving, and the Rate of Interest," in Journal of Political Economy, vol. 86 (1978) pp. 53-527. Martin Feldstein, "Adjusting Depreciation in an Inflationary Economy: Indexation versus Accelerated Depreciation," National Bureau of Economic Research working paper #395, 1979. Martin Feldstein, "Inflation, Tax Rules and the Stock Market," in Journal of Monetary Economics, vol. 6 (1980), pp. 309-331. Martin Feldstein, "Inflation, Tax Rules and the Accumulation of Residential and Non-residential Capital" Seminar Paper No. 186, Institute for International Economic Studies, University of Stockholm, November 1981. Martin Feldstein, "Inflation, Tax Rules and Investment: Some Econometric Evidence," Econometrica, vol. 50. No. 4, July 1982. Martin Feldstein and Lawrence Summers, "Inflation, Tax Rules and the Long Term Interest Rate" in Brookings Papers on Economic Activity, 1978, pp. 61-109. Dale Jorgenson and Roger H. Gordon, "The Investment Tax Credit and Countercyclical Policy," Cambridge, Massachusetts, Harvard Institute of Economic Research Discussion Paper No. 373, June 1974.

3 Otto Eckstein, Tax Policy and Core Inflation, A Study Prepared for the Use of the Joint Economic Committee, Congress of the United States Washington, U.S. Government Printing Office, 1980.

4 Allen Sinai, Andrew Lin and Russel Robins, "Taxes, Saving and Investment: Some Empirical Evidence," in National Tax Journal, vol. 36 (1983).

STATEMENT OF J. JACKSON WALTER, PRESIDENT, NATIONAL ACADEMY OF PUBLIC ADMINISTRATION, WASHINGTON, DC

Mr. WALTER. Senator, good morning.

As president of the National Academy of Public Administration, I am delighted at the opportunity to testify before the Subcommittee on Oversight of the Internal Revenue Service on the subject of the Administrative Impacts of Tax Reform.

A member of the National Academy's executive committee and a former Commissioner of the Internal Revenue Service, Sheldon Cohen will appear on your second panel, and I would be delighted to defer to him with respect to your more difficult questions.

The National Academy is committed to the search for excellence in Government and supports this subcommittee's concern with the potential problems of implementing and administering whatever tax reforms might emerge from the next Congress.

Only last April, President Reagan signed legislation granting a Federal charter to the National Academy in recognition of our past and future work on such questions. This was only the second such charter granted to an organization of our kind in the past 150 years—the other being granted to the National Academy of Sciences in the 1860's.

Though the National Academy does not support or oppose any specific set of tax reforms, we are particularly concerned about the potential administrative impacts. The National Academy believes that a fair and simple tax, and for that matter a complicated tax, can be neither fair nor simple if it cannot be administered.

There is little doubt that tax reform will be at the top of the congressional agenda next year. There are dozens of proposals already circulating on Capitol Hill, and the acronyms are staggering. The list of ideas runs the gamut of recent tax proposals from Flat Taxes to Cash-Flow Taxes to Consumed Income Taxes to National Sales Taxes. As this committee already knows, there are a number of ways of comparing the proposals. Some involve fairness and equity, others focus on complexity and ease of understanding.

The National Academy of Public Administration, however, is concerned with yet another way of comparing the tax reform alternatives—their administrative impacts. The National Academy believes that every policy action creates an equal or greater administrative reaction, and is concerned with making the policies work once the legislative debate is over. The battle on tax reform is already moving forward on several fronts.

All of the reforms search for fairness, but in very different ways. All seek economic efficiency in the hope that the tax system will have a neutral impact on consumer choice. All hope to stop punishing work and savings; all want simplicity; yet virtually none of the current proposals confronts the issue of administrative impacts.

Though some of the reforms are obviously difficult to implement, there has been little comparison of such administrative effects. Therefore, the National Academy applauds this subcommittee's interest in the question and hopes to remain active in the hearing process.

Five questions are prominent in the National Academy's analysis of the administrative impacts:

First, how do the competing tax reforms compare on administrative costs? Just how much will each tax cost to administer? Here the focus is on net revenues.

Second, how do the tax reforms compare in terms of staff and organizational demands? Will the Internal Revenue Service need more staff, more enforcement funding? The National Academy is particularly concerned with any necessary reorganization. It is not enough to simply pass a tax bill without considering the potential impact on the Internal Revenue Service.

Third, how will the tax reforms be implemented? The National Academy is interested in both the ease and speed of implementation and in the time and costs for compliance by taxpayers. The Brookings Institution's cash-flow tax, for example, would take 3 years to implement, with a complex array of transition formulas.

Fourth, what kinds of information and data will be needed to monitor and enforce the various tax reforms? Here the National Academy shares the subcommittee's concern with taxpayer confusion and paperwork demands.

Fifth and finally, can the various tax reforms be enforced? The National Academy is concerned with the ultimate enforcement of each option. Some are easier to evade than others. The VAT, for example, has a much greater potential for tax avoidance than a national sales tax. Since the IRS is ultimately responsible for this enforcement, it would be a major issue for any study that we would conduct on this topic.

The National Academy hopes that the subcommittee will remain interested in and active on this general matter. Administrative impacts should not be a secondary issue in tax reform. We believe that these questions must be part of any comprehensive tax-reform debate. Indeed, this is about the only question that has been neglected both by the Congress and by the President; yet it may very well be the single most important issue in terms of simplifying the tax system. If Government cannot administer the reforms, there is no reason to raise public expectations that we will finally have a simple tax.

Once again, we believe that a fair and simple tax can be neither fair nor simple if it cannot be administered.

Thank you.

[Mr. Walter's prepared statement follows:]

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NATIONAL ACADEMY OF PUBLIC ADMINISTRATION
1120 G Street, N.W.
Washington, D.C. 20005

"ADMINISTRATIVE IMPACTS OF TAX REFORM"

STATEMENT OF

J. JACKSON WALTER,
PRESIDENT

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

SENATE COMMITTEE ON FINANCE

For Release on Delivery

Monday, September 17, 1984

The National Academy of Public Administration is delighted at the opportunity to testify before the Subcommittee on Oversight of the Internal Revenue Service on the subject of the administrative impacts of tax reform. The National Academy is committed to the search for excellence in government, and supports this Subcommittee's concern with the potential problems of implementing and administering whatever tax reforms might emerge from the next Congress. Only last April, President Reagan signed legislation granting a Federal charter to the National Academy in recognition of our past and future work on such questions. It was only the second charter granted to such an organization in the past 150 years—the other was granted to the National Academy of Sciences in the 1860s.

Though the National Academy does not support or oppose any specific set of tax reforms, we are particularly concerned about potential administrative impacts. The National Academy believes that a fair and simple tax can be neither fair nor simple if it cannot be administered. The National Academy has been working recently to secure funding for a comprehensive study of the administrative impacts of tax reform, and believes that such a study can be an important aid to future congressional action.

There is little doubt that tax reform will be at the top of the congressional agenda next year. There are dozens of proposals already circulating on Capitol Hill, and the anachronims are staggering--FAST, FAIR, GIT, UCT, VAT, and so on. The list of ideas runs the gamut of recent tax proposals--from flat taxes to cash-flow taxes to consumed-income taxes to national sales taxes. As this Subcommittee already knows, there are a number of ways of comparing the proposals. Some involve fairness and equity. Others focus on complexity and ease of understanding.

The National Academy of Public Administration, however, is concerned with still another way of comparing the tax reform alternatives: **administrative impacts**. The National Academy believes that every policy action creates an equal or greater administrative reaction, and is concerned with the problems of making policies work once the legislative debate is over. After detailed discussions with National Academy members, including former Internal Revenue Service Commissioner Sheldon Cohen, former Deputy Commissioner Bertrand Harding, Rep. Barber B. Conable, Jr., and former Senate Government Affairs Committee Staff Director Richard A. Wegman, the National Academy has completed preliminary planning for a study administrative impacts of tax reform. The National Academy believes it is qualified to undertake such a study, and hopes to secure the funding necessary to complete this work by the start of the 99th Congress. Because of its nonpartisan character, the National Academy cannot be concerned with the political issues of tax reform. But we are extremely interested in the implementation and administration of any comprehensive tax reform bill.

Clearly, the pressure for tax reform will not abate. Indeed, as the Brookings Institution recently argued, "a prosecuting attorney would have no difficulty persuading an impartial jury to convict the federal income tax system on several counts: it diverts resources away from their most productive uses, it is complex, and it is unfair." That indictment is repeated by virtually every student of our current tax code. Though the search for equity has produced at least part of the current complexity, the tax system surely needs repair. Such repair cannot succeed, however, without attention to the day-to-day issues of administration. Replacing one complex system with another is no answer to the current complaints.

But if most agree that the current system needs reform, few have agreed on a specific proposal. The agenda of tax reform includes a dizzying array of proposals. The Reagan administration has not announced its proposal, but appears to be interested in sales taxes and value-added taxes. Congressional actors have not been so quiet: Bradley and Gephart have a flat tax called FAIR; Kemp has one called FAST; Quayle and DeConcini have flat taxes with very different impacts; a national sales tax appears to be favored by the public over most other options; and the value-added tax is still alive. Moreover, even if everyone suddenly agreed on a single proposal, the transition to the new system might take years, involving temporary surcharges. The administrative issues are both complex and demanding.

Consider, for example, the value-added tax. However simple the VAT may be in theory, it is anything but simple in practice. According to a series of studies by the Brookings Institution, the European experience holds ample evidence. Six nations currently use the VAT: France, Germany, Italy, the United Kingdom, Sweden, and the Netherlands. While it is difficult to measure the overall success of each system, administrative impacts are readily comparable.

In theory, the VAT is a uniform tax that minimizes distortion in consumption rates. By taxing the "value added" to a commodity at each stage of its production, a uniform rate can be applied to every consumer. All six European nations have chosen, however, to achieve at least some progressivity in the VAT by allowing exemptions. All six have different rates for agricultural and other essential commodities. Unfortunately for administrators, any time an exemption is added to a supposedly flat tax, the complexity grows. While these European nations have achieved some measure of fairness, they have also increased their administrative costs and complexity.

First, all must make arbitrary distinctions for firms deserving lower tax rates. Italy, for example, employs five different rates. The procedure for classifying and evaluating each product and firm has become a burden on both the governments and the firms. The quarterly returns required for proper classification create a mountain of paperwork. Even if the United States adopted a more uniform VAT to cut down on complexity, Congress would have to accept increased administrative costs, along with the taxpayer outcry. Small businesses would have to adopt extensive and expensive record systems.

Moreover, it is not clear that a VAT could be enforced. According to Brookings, there is a 40 percent average evasion rate in Italy. Yet, even where there is little intentional evasion of the VAT—as in Britain--the smaller firms simply cannot keep up with the expenses and volume of the recordkeeping. In the U.S., with its much higher proportion of small businesses, the VAT would require remarkable changes in the way most firms operate. The VAT system could create a bureaucratic nightmare, with vast increases in administrative costs, taxpayer headaches, and a loss of Internal Revenue Service efficiency.

This is not to single out VAT for special criticism. Indeed, it should serve as an example of what needs to be known about the rest of the tax agenda. The VAT tax is one of the few that we have studied in detail. From what we know, it would be difficult to administer. The point is that we have not even scratched the surface for the rest of the tax menu. Brookings, for instance, has proposed a cash-flow tax, and has admitted that it would have some transitional problems, and might be difficult to administer at the start. But we do not have hard administrative information on that tax, or on most of the proposals. The National Academy believes Congress must have that knowledge to make the coming choices.

The battle on tax reform is already moving forward on several fronts. All of the reforms search for fairness, but in very different ways. All seek economic efficiency, in the hope that the tax system will have a neutral impact on consumer choice. All hope to stop punishing work and savings. All want simplicity. Yet, virtually none of the current proposals confronts the issue of administrative impacts. Though some of the reforms are obviously difficult to implement, there has been little comparison of such administrative effects. Therefore, the National Academy applauds the Subcommittee's interest in the question, and hopes to remain active in this hearing process.

There are five questions in the National Academy's study of administrative impacts:

1. How do the competing tax reforms compare on administrative costs? Just how much will each tax cost to administer? Here, the focus is on NET revenues.

2. How do the tax reforms compare in terms of staff and organizational demands? Will the Internal Revenue Service need more staff, more enforcement funding? The National Academy is particularly concerned with any necessary reorganization. It is not enough to simply pass a tax without considering the potential impact on the IRS.

3. How will the tax reforms be implemented? The National Academy is interested in both the ease and speed of implementation. The Brookings Institution's cash-flow tax, for example, would take three years to implement, with a complex array of transition formulas.

4. What kinds of information and data will be needed to monitor and enforce the various tax reforms? Here, the National Academy shares the Subcommittee's concern with taxpayer confusion and paperwork demands.

5. Can the various tax reforms be enforced? The National Academy is concerned with the ultimate enforcement of each option. Some are easier to evade than others. A VAT, for example, has a much greater potential for tax-avoidance than a national sales tax. Since the IRS is ultimately responsible for this enforcement, it is a major issue for our study.

The National Academy hopes that the Subcommittee will remain interested and active on this general topic. Administrative impacts should not be a secondary issue in tax reform. We believe that these questions must be part of any comprehensive tax reform debate. Indeed, it is the only question that has been neglected by Congress and the President. Yet, it may very well be the single most important question for simplifying the tax system. If government cannot administer the reforms, there is no reason to raise public expectations that we will finally have a simple tax. Once again, we believe that a fair or simple tax can be neither fair nor simple if it cannot be administered.

Senator GRASSLEY. Let me start right where you left off; although that wasn't my intention, it is fresh in our minds. Administerability.

Is it too simple to take as a given, then, if we do anything that eliminates much of the Tax Code, we do those things that lessen the total number of—let me just use the word "loophole," although I know that is not a very fair word to use—or lessen the size of the income tax form that the individuals or the professionals have to make out? Can't we accept that as it's going to address the problem that you raised, that we have not addressed yet?

And then, opposite that, if we do more like we did in 1984, administerability is just going to be worse.

Mr. WALTER. It seems to me Mr. Huard spoke marginally to that question in his testimony. The one thing I would want to say is that, as you move forward with whatever bill you want to do next year, and the National Academy doesn't want to take a view on the relative merits of any of the contending proposals, Senator; it certainly seems to me that the manner of integration of whatever the tax system will be following your legislation should be a central subject. How are you going to work with whatever you have left of the old code and the new code, how you are going to fit them together, and what kind of a package will you have left at the end, are issues that we hope the Congress will address while it is proceeding and not simply defer to be worked out later.

Mr. HUARD. I think that most of the major overhaul proposals would, if anything, be less administrable than the current code, and particularly with regard to their impact on individual taxpayers. I think business taxpayers of necessity are used to a great deal of complexity. You know, they are required to keep things like balance sheets and profit and loss statements. This is something that individual taxpayers are not required to do. I think if you get into all of the major overhaul proposals you will find that one of the ways they try to soften the pain of doing away with a lot of deductions and credits is by lowering the rates. But lowering the rates results in the system producing less revenue. So another counterpart to all of these proposals is broadening the base. Well, when you broaden the base you start doing a lot of things like including things in individual taxpayers' incomes that have never been included before—the value of employer-paid benefits; some of the systems like the cash-flow or consumed-income systems would have you include the value of loans taken out as income during that year. You would be imposing a recordkeeping burden on individual taxpayers, in my judgment, that would far exceed anything they have had to put up with in the past. And I think that is a real flaw of most of the major overhaul proposals that I have seen. It is not just a question of simplifying the system by doing away with existing exclusions, deductions, and credits. What you have done is immediately replaced that with a further complication by broadening the base and requiring them to account for, report, and pay tax on things they have never paid tax on before.

Senator GRASSLEY. Paul, you are the only one on any of the panels today that represents a major interest group here in the Washington, DC scene, so I would like to ask you not only for your part, although I suppose you can speak more for the NAM than

any other interest group in town, if there is going to be a major simplification of the tax system, a major overhaul of the tax system, interest groups generally are going to have to be part of the process or it is not going to happen—that is the way I see it.

Do you see a movement among interest groups to be supportive of such efforts? And, if not, then is there going to be an effort to so be? Because I guess I take the view that, you know, it is going to be a partnership between those of us in the Congress and groups that we work with here in Washington to accomplish this.

Mr. HUARD. Certainly the effort will be made. The NAM is part of a coalition of a half dozen or so major business associations which is trying to look at the overall issue of Federal tax and fiscal policy. You know, we have multiple goals in mind. One of them, of course, is tax policy; but the other is fiscal policy, spending reductions, overall reduction of the deficit.

At this point I must say that we are the only major association that has reached a specific position on tax policy side. I think, as a practical matter, it is going to be a lot easier to get interest groups to agree on, say, a broad generic package of spending reductions. I think, for instance, you will find wide business support next year for entitlement reform which takes the line that cost-of-living adjustments to entitlements such as Social Security and retirements are valid instruments, but that they shouldn't be indexed 100 percent to the current increase in CPI, that there should be some paring back of that either to the CPI-Minus-2, which is one of the formulas in some legislation that has been introduced this year, or something like 60 percent of CPI. And I think it is going to be easier to reach a broad consensus of interest groups on something like that than it is on tax policy.

We are hopeful that we can get as many groups as possible pulling in the same direction, and I guess to some extent our support of a transactions-type of tax as a new revenue source is an example of perhaps the best defense being a good offense. We obviously aren't interested in further increases in business taxes or in further reductions in capital formation incentives, but we do realize that Congress will be under a considerable amount of pressure to not just maintain the existing revenue being generated by the Tax Code but actually to increase it, given the state of Federal deficits. And we feel that basically shifting away from what we regard as already an over-reliance on income taxation towards taxation of consumption is the proper approach. And we are hopeful that we can get a fairly substantial number of business groups thinking that way. It is an educational process and I won't make any predictions, but we are moving in that direction, and I am hopeful that we can get some kind of consensus.

Senator GRASSLEY. You are moving in that direction now and have been for several months to have a consortium of business groups meet periodically to discuss things along this line, to discuss possible strategies?

Mr. HUARD. That is correct, Senator. Yes, sir.

Senator GRASSLEY. Is that a fairly sophisticated operation, or at this point is it very loosely knit?

Mr. HUARD. Loosely knit is probably a better description than "sophisticated." You know, all of the associations involved have

been just using their existing resources and existing staff. We haven't hired any new staff or gone out and bought a million dollars worth of computer time, so it is probably more loose than it is sophisticated at this point.

Senator GRASSLEY. You are pessimistic when you say that dramatic changes are going to be difficult because too many applecarts will have to be upset. Do you see that as an impossible effort, or one that can be accomplished?

Mr. HUARD. Oh, I don't see it as an impossible effort; I see it as an effort that would be far easier to achieve if the Federal Government were less reliant on income taxes for its revenues. This, again, is one of the incidental benefits of shifting towards some kind of consumption tax, if you can reduce the present Government reliance on income taxation. For instance, the corporate and individual income tax produce about 55 percent of all Government revenues. If you could reduce that, say to 40 percent, the system would be less sensitive. If you were willing to reduce the take from the income tax system, I think you would substantially enhance the likelihood of achieving major reform of the income tax system. I think it has been observed by any number of veteran tax policy players such as Barber Conable on the House side that achieving tax reform where you are taking away whatever you call them—loopholes, deductions, preference items—is a lot easier to do if at the same time you are reducing everybody's taxes or almost everybody's taxes.

Well, you know, as a practical matter we really can't do that. We can't afford to take in even less Government revenue than we are already taking in; even at the present level we are looking at substantial deficits stretching out indefinitely, and I think the only type of approach which would permit you to lower the Government take from the income tax and therefore enhance the possibilities of reforming the income tax, because it's less significant, is to return to another totally new source of revenue which we really never tapped in this country other than in a very minor and incidental way through alcohol and tobacco taxes and telephone excise taxes.

So my pessimism is based on revenue-neutral reform. I think all of the so-called proposals, including the one the administration apparently will come out with in December, are ostensibly going to be revenue-neutral; they are going to raise exactly as much revenue as the current system.

The problem I have with that is that when you have that kind of reform and you're taking away a lot of existing preference items—loopholes, whatever you want to call them—you can claim as Senator Bradley does that within broad income classes everybody's tax liabilities stay the same, but what he is really saying is that we have 10 million winners and 10 million losers. I mean, it all evens out within the income class, but you have hurt an awful lot of people, and those people are going to very vocal, and they are going to be contacting their representatives in the Congress. It is going to make the job much more difficult. Whereas, if you are not doing that, if you are not really substantially increasing anybody's income tax liabilities because you have cut back on the overall take from the income tax system, I think it enhances the likelihood that

you can achieve substantial reform and simplification of the income tax.

Senator GRASSLEY. Mr. Walter, from the standpoint of your Academy, you are mostly interested in administerability of the particular tax systems or changes we make as opposed to the substantive proposals—I mean the tax policy itself. Is that right?

Mr. WALTER. Yes, sir.

Senator GRASSLEY. OK. Well, from that standpoint then, what do you consider the single most serious flaw, or maybe I could say a small number of serious flaws, of our present net income tax system? And what advice would you have to Congress to correct that or those?

Mr. WALTER. Senator, I think that the comments of the Brookings Institution—they said that a prosecuting attorney would have no difficulty in persuading an impartial jury to convict the Federal income tax on several counts, of diverting resources away from the most productive uses, of complexity, and unfairness—is a catalog of abuses that is really more or less a given entering into these hearings.

It seems to me that from the point of view of the National Academy, the concern that we are trying to advance is the notion that, during the consideration of the relative policy merits of the proposals put before you, you also keep in mind and attempt to balance equally the administrative difficulties of implementing and operating the several proposals rather than deferring consideration of their administerability until after the law has been passed, when suddenly the Internal Revenue Service or the taxpaying public or the corporate taxpaying recordkeepers, or whomever, suddenly discovers that they have been saddled with yet a new and large paperwork burden or an enforcement burden in service, or a collection burden, or whatever it may turn out to be, that was never discussed during the legislative process.

Attempting to move that administrative issue up on the agenda so that it is considered at the same time as the policy merits of the proposals is my reason for being here this morning.

Senator GRASSLEY. All right. I believe that that is the end of my questioning for this panel. I thank you very much and ask you to anticipate that there might be questions from members of the Committee who can't be present today, and if not now surely will be next year.

Thank you very much.

Mr. HUARD. Thank you, Senator.

Mr. WALTER. Thank you, Senator.

Senator GRASSLEY. The second panel consists of four individuals very learned in these aspects of the Tax Code that we are now discussing:

Phil Storrer—and I hope I pronounce that right. Mr. Storrer. Yes.

Senator GRASSLEY. He is currently professor of accounting and taxation, California State University, Hayward, CA. He served 8 years as Agent, Instructor, and Manager for IRS in Los Angeles; he holds an MBA from Golden State University in San Francisco, has written two books on taxation and IRS management, and is founder of the California State University Graduate Tax Program.

Sheldon Cohen has testified many times before this committee both as a private citizen and as a public official, is currently a partner in Cohen and Uretz law firm, practices law before the various courts of this country including the U.S. Supreme Court, was Chief Counsel in the IRS from 1963 to 1965 and then was Commissioner from 1965 to 1969.

John Kendrick is currently Professor of Economics at George Washington University, currently adjunct scholar at the American Enterprise Institute, former chief economist at the Department of Commerce, and vice president of economic research for the conference board, New York.

And David Bradford, currently professor of economics and public affairs at the Woodrow Wilson School, Princeton University, a B.A. from Amherst College, an M.S. from Harvard, Applied Mathematics, and Ph.D. from Stanford University in 1963. He studied at Cambridge University and was Deputy Assistant Secretary for Tax Policy in 1975–1976, and was also on the staff of the Federal Reserve Board for a period of time.

I welcome each of you and would ask you to proceed in the way that I introduced you, and then each of you finish your testimony before I have questions.

Mr. Storrer?

STATEMENT OF PHILIP STORRER, PROFESSOR, SCHOOL OF BUSINESS AND ECONOMICS, CALIFORNIA STATE UNIVERSITY, HAYWARD, CA

Mr. STORRER. Thank you, Mr. Chairman.

I appreciate this opportunity to again appear before your committee. I am representing myself in these hearings.

Today there is a deep desire and pronounced need for a massive reform of our tax system, and my conviction with respect to that stems from my personal experiences as well as my professional ones. I think there is a growing number of tax professionals who share this concern, and that is the feedback that I get from continuing education tax seminars that I do throughout the country.

Misconceptions concerning tax reform, however, are widespread. There is a deep need, I believe for public education regarding the fundamentals of tax reform. Two overriding prerequisites I believe are essential to real tax reform.

These prerequisites, which I describe as the pureness of purpose and clean-slate prerequisites, are aptly expressed I believe in the quotes that I have included in my notes, from President Reagan and from the current Commissioner, Roscoe Egger.

The pureness of purpose, or the proper purpose of taxation was described by President Reagan in his address to Congress on February 18, 1981: "The taxing power of Government must be used to provide revenue to finance prudent Government expenditures. It must not be used to regulate the economy or bring about social change. We have tried that, and surely we must know it does not work."

The clean-slate prerequisite was appropriately described by Commissioner Egger in his speech before the Commonwealth Club in San Francisco on April 13, 1984: "Americans don't resent paying

taxes. They resent not being able to figure out what their share really is. If we want more than a piecemeal approach to reform, we must leave behind preconceived notions about the American tax system. No deductions, exemptions, or credits can be considered sacred cows."

I believe that these comments provide an excellent base from which real reform can stem. I am very much encouraged by the efforts of this administration and of your subcommittee, Mr. Chairman.

I want to quickly summarize several observations I have regarding aspects of massive reform.

Correcting misconceptions is an important but difficult educational process, and I believe that this process is made more difficult by the careless use of language. George Orwell in 1946 in his essays on politics and English language said that "slovenliness of language makes it easier to have foolish thoughts," and I would plead guilty to that, Senator, and I would add that it probably leads to careless actions.

Taxation is not a positive influence in our society as many believe. It is a very necessary influence, but not a positive influence. Taxation is necessary to finance prudent Government expenditures, and I believe that it is misleading to title and describe tax acts with words that indicate positive influence. Titles to recent acts create this misimpression, such as "The Fair Tax Act," or "The Fair and Simple Tax Act." I judge them to be neither.

Many do not understand that simplicity and equity in the purest sense are incompatible objectives. When we provide for equity, we sacrifice simplicity—the more equitable we make the system, the more complicated it becomes, to the point that under our current system we have neither.

A third misconception is that progressive rates cannot be justified on economic grounds. They can be justified on emotional grounds, but not on economic grounds. The utility theory concepts do not really help in this area.

Several other areas I think deserve some quick comment:

The public also needs to fully understand that flat tax or broad-based tax systems mean no more favored deductions, credits, or exclusions in the extreme. The sacrificial unwillingness or willingness of the public is in my opinion questionable. The public in many sectors believe that a flat tax would mean lower taxes for everybody. What is the base for flat tax purposes is another question yet to be resolved — 10, 15, 20 percent of what? There are many other areas that deserve consideration.

There is, I believe, justifiable concern also over the transition from our existing system to a flat tax or a broad-based system; but I believe perception is one thing and reality is often quite another.

I ask the question somewhat rhetorically: Do we really know what the effect of changing from one system to another might be? I personally am not convinced that a drastic change would be devastating. The transition from our existing system to a flat-tax system could be accomplished in one or more of several ways—some of them include setting a target date and then changing all at once, giving taxpayers time to plan for this change; a second way would be to gradually transition in steps toward that ultimate broad-

based system. This could be accomplished by expanding the existing alternative minimum income tax, section 55 approach, and then contracting the regular tax. We could also grandfather in certain prized possessions such as interest and tax deductions for homes, or a use of a combination of them.

I believe the educational process will not be easy, but it should take place in an atmosphere of openness and free exchange.

The political realities alluded to earlier, I believe, regarding massive change, given private interest group influences, are overwhelming. Tax changes are currently used to respond to pressure of private interest groups, including the Internal Revenue Service. The successful efforts of private interest groups demonstrate I believe a systemic flaw.

There is in our system a concentration of benefits and a diffusing of costs dichotomy. Those benefiting from special provisions can afford to spend time lobbying; those paying the costs cannot afford to make their feelings felt. Flat tax reform, in my opinion, addresses this systemic flaw by allowing those otherwise financially unable to make their feelings felt. It concentrates the costs of taxation and diffuses the benefits, thereby reversing this process.

I have a couple of suggestions regarding the type of reform, perhaps, that is needed. I think the failure of the incrementalistic approach is now well known. Seventy-one years of tinkering has brought us a system which now does not function effectively. It is being disabled by tax protesters, abusive tax shelters, and the underground economy. There is a definite need for a change in the method of taxation, I believe. I personally favor a consumption or income-based value-added tax which could be administered in a simplified way. Who must file tax returns should be limited to, in my opinion, individuals who are businesses and eliminate the need for non-business tax returns to be filed.

Tax reform cannot take place without considering the spending issue. The inseparability of tax system reform and governmental spending must be acknowledged by all. It is politically impossible to have tax reform of the kind that I believe the public expects without spending cuts.

In conclusion, tax administration is not in good health. The battle against evasion and illegal avoidance is being lost, in spite of the fine efforts of the Internal Revenue Service. It is unreasonable to expect the Internal Revenue Service to solve problems, given the complexity of the law. I believe the public is being civilly disobedient, because they feel their protests are not being heard. In short, confusion abounds.

I have included a couple of statements by ex-Revenue agents now in private practice as CPAs which pay tribute to this confusion.

One thing is unalterably clear: If we do nothing, the public will do it for us, with more ridiculous tax protester and abusive tax shelter activities. If the public is successful with this type of crude personal tax reform, the fires of real tax reform will wane, if not all but disappear. When everyone has their own little brand of tax reform, fundamental reform will become unnecessary, and we will be worse off for it.

For these reasons I see 1985 as a most critical year. I was impressed yesterday while walking the Mall and reading the inscrip-

tions of our forefathers regarding their clear thinking concerning fundamentals. It reminded me of the psalmist who wrote, 'If the foundations be destroyed, what shall the righteous do?' I trust the righteous will act responsibly.

Thank you, Mr. Chairman.

Senator GRASSLEY. Thank you.

Mr. Cohen.

[Mr. Storrer's prepared statement follows:]

STATEMENT OF PHILIP P. STORRER

September 17, 1984

I. General remarks indicating that there is a deep desire and pronounced need for massive reform.

A. My perception of public concern for tax reform from my personal contacts which include the following:
1. My speaking engagements
2. Our university VITA program
3. My radio and talk shows, and
4. My consulting practice

B. Tax practitioners are very concerned. This is the feedback I get from continuing education tax seminars I do around the country.

II. There is a deep need for public education regarding the fundamentals of tax reform. Two overriding prerequisites are essential to real tax reform. These prerequisites are aptly expressed by the following quotes from President Ronald Reagan and Internal Revenue Service Commissioner, Roscoe Egger:

A. The purpose of taxation prerequisite:

"The taxing power of government must be used to provide revenue to finance prudent government expenditures. It must not be used to regulate the economy or bring about social change. We have tried that and surely we must know it does not work." - President Ronald Reagan February 18, 1981, before Congress in presenting his economic package.

B. The "Clean slate" prerequisite

"Americans don't resent paying taxes. They resent not being able to figure out what their share really is . . . . If we want more than a piecemeal approach to reform, we must leave behind preconceived notions about the American tax system. No deductions, exemptions, or credits can be considered sacred cows". - Internal Revenue Service Commissioner Roscoe Egger April 13, 1984, San Francisco, speech before the Commonwealth Club.

C. These comments provide an excellent base from which to build real tax reform. I am very much encouraged by the efforts of the administration and the efforts of the Finance Committee and your Subcommittee, Mr. Chairman. In short:

1. The tax system should be used to produce needed revenue.
2. No one's ox can be exempt.

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STATEMENT OF PHILIP P. STORRER

September 17, 1984

III. Specific observations I have regarding various aspects of massive tax reform.

A. It is important to analyze the practicality of massive change.

1. Correcting misperceptions is an important educational process.
   a. Taxation is not a positive influence in our societies, as many believe. It is a very necessary influence, but not a positive influence. Taxation is necessary to finance prudent government expenditures. It is misleading to title acts with words that indicate a positive influenced titles to recent acts create the wrong impression. For example:
      1). "Fair Tax Act" and
      2). "Fair and Simple Tax Act"
   b. The original intention of the Constitution Framers sheds light on the purpose of taxation. - IRM §1111.31 says:
      1). "Madison's notes on the Constitutional Convention reveal clearly that the framers of the Constitution believed for some time that the principal, if not sole, support of the new republic would be derived from customs and duties and taxes connected with shipping and importation. Internal taxation, would not be resorted to except infrequently, and for special reasons."
      2). Statements made during the debates over the Revenue Act of 1913 indicate that the income tax rates were not expected to ever rise above 10%.
   c. Simplicity and equity in the purest sense are incompatible objectives. When we provide for equity, we sacrifice simplicity. The more equitable we make the system, the more complicated it becomes.
   d. Progressive rates cannot be justified on economic grounds. They can be justified only on emotional grounds. The ability to pay concept is not an economic concept. Utility theory does not solve the problem.
   e. Specific areas of public misperception include the following:
      1). The public needs to understand that a flat tax means no more favored deductions, credits, or exclusions. Several considerations relate to this consideration:
         a). Sacrificial willingness of public is, in my opinion, questionable. Is the public really willing to offer their own individual oxen?

STATEMENT OF PHILIP P. STORRER

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b). The public thinks that a flat tax rate would mean a lower tax for everyone.
c). What is the base for flat tax purposes? 10% or 20% of what?

2). The public thinks that the Internal Revenue Service makes the law.
3). The public thinks that the Internal Revenue Service is omniscient - a myth that is being rapidly replaced by the underground generation.
4). The public in some sectors thinks that the Internal Revenue Service has power which is the fiscal equivalent of Nazi Germany - and freely uses it to harass taxpayers.
5). The public in some sectors thinks that tax experts know what is going on and how to engage in tax planning to avoid all taxes whenever they wish.
6). Congress understands completely the laws it is encouraged by special interest groups to enact.

B. Concern over the transition from our existing system to a flat tax system.

1. Perception vs. Reality!! Do we really know what the effect would be?
2. Equity vs. Practicality of changing from our existing system to a flat tax system.
   a). Elderly people anticipating the §121 exclusion for sale of their residence at age 55.
   b). Municipal bond interest investments for retirement are currently tax free. Would it be fair or constitutionally proper to suddenly tax them?
3. The transition from our existing system to the flat tax system could be in one or more of four ways:
   a). Set a target date for change and make the change all at once. This would give taxpayers time to plan for the change.
   b). Gradual transition in steps toward the ultimate objective of a flat tax system. This could be accomplished by expanding the existing alternative minimum tax to a broader base while simultaneously reducing the influence of the regular tax.
   c). Grandfathering certain prize provisions such as interest and taxes on homes.
   d). Use a combination of the above alternatives.

4. The process of Education - How to accomplish it!!
   a). Testimony of this type
   b). Speeches
   c). Debates
   d). Talk shows
   e). Articles
   f). News releases

STATEMENT OF PHILIP P. STORRER

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g). ALL OF THESE DISCUSSING, HOWEVER, SHOULD TAKE PLACE ON A CLEAN SLATE WITH NO PRECONCEIVED NOTIONS.

5. The political Realities of Massive Change
   a. Private interest group influences are overwhelming. Tax changes are currently used to respond to the pressure of private interest groups including the Internal Revenue Service.
      1). We all know of classic examples
      2). Flat tax proposals with catchy titles are themselves examples - the terminology itself is used to indicate the good we're doing for the public.
      3). The reality of the political process causes even the most principled of us to react politically. e.g. The Reagan administration and its support for real estate tax deduction. We should encourage this process, but only when it is in response to pressures of generally informed public.

   b. The successful efforts of private interest groups demonstrate a systemic flaw. - There is in our system a concentration of benefits and diffusing of costs dichotomy. Those benefiting can afford to spend time lobbying. Those paying the cost cannot afford to make their feelings felt. Flat tax type reform addresses this systemic flaw by allowing those not otherwise financially able to make their feelings felt.

C. Suggestions regarding the type of reform needed.
   1. The failure of the incrementalistic approach is now well known.
      a. "We have tried that and, surely, we must know it does not work". - President Ronald Reagan supra
      b. 71 years of tinkering has brought us a system which now does not function effectively. It is being disabled by tax protesters, abusive tax shelters, and the underground economy.
   2. There is a definite need for a change in the method and approach.
      a. We must decide fundamental issues first. Preconceived notions about taxation must be destroyed.
      b. The purpose of taxation must be considered. We must use the system to produce revenue to finance prudent government expenditures.
      c. We can then address the question as to what type of system we desire to raise this revenue.
   3. A consumption or income base value added tax is a possibility.

STATEMENT OF PHILIP P. STORRER

September 17, 1984

The general VAT tax model is viewed as follows:

Consumption Base VAT
All income (Broadly defined)
Less: Expenses related to the production of income (including capital purchases)
Equals: value added on consumption base

Income Base VAT
All income
Less: Expenses related to production of income not including capital purchases
Less: depreciation (Recovery)
Equals: value added on income base

4. Administration of the tax could be simplified.
   a. Who must file could be limited.
      1). Eliminate individual non-business taxpayers by requiring that only businesses file returns.
         a). This could be done by allowing no deduction for factor payments to households - wages, interest, and rent are examples of factor payments to households.
         b). Deductions will only be allowed if paid to other businesses.
         c). W-4s could be used by businesses to avoid withholding.
         d). W-4s/1099s can then be matched with recipients return to see that they are properly reported.
   b. To eliminate the need for wage earners to file returns see model described in exhibit A.

D. The inseparability of tax system reform and governmental spending must be acknowledged by all.
   1. Governmental spending is taxation. - Deficit spending must be paid sometime and by us. No outside philanthropist is going to pick up the tab.
   2. Tax reform does not, therefore, mean lower taxes - not without reduced spending.
   3. It is politically impossible to have tax reform of the kind the public expects without spending cuts.
   14. The public must see the connection between spending and taxation. They must see that they are getting their money's worth.

IV. Conclusion

A. Tax administration is not in good health. The battle against evasion and illegitimate avoidance is being lost in spite of the fine efforts of the Internal Revenue

Service. It is unreasonable to expect that the Internal Revenue Service can solve the problem given the complexity of the law.

B. In short, confusion abounds.

C. Ex-Internal Revenue Service agents, I chat with, agree. Two recent conversations bare this out:
1. "I cannot believe how screwed up the system is. When I was with the Service, we thought the problems were the exception. Now that I'm out I see that they are the rule. Other Ex-Revenue agents share my feeling.

   You never know exactly what they are going to do so it makes us look like idiots. I've been amazed since I've been out of the Service how screwed up they are, and it is getting worse not better". - An Ex-Group Supervisor now in private practice as a Certified Public Accountant.

2. "Tax planning is not possible in the current environment with one monumental tax change after another." - Ex-Assistant Chief Examination Division now in private practice as a Certified Public Accountant.

D. One thing is unalterably clear that if we do nothing, the public will do it for us with more ridiculous tax protester and abusive tax shelter activities. If the public is successful with this type of personal crude reform the fires of real tax reform will wane, if not all but disappear. When everyone has their own little brand of tax reform, fundamental reform will become undesirable. We will be worse off because of it. For these reasons, I see 1985 as a most critical year.

FORM 1040 FLAT TAX

Line 1 All income (§61 without the current exclusions)

Line 2 Less expenses related to the production of income

Line 3 Plus factor payments to households for which no W-4 indicating business status of recipient is on file with payor

Line 4 Equals: Tax base - Includes taxable Income of taxpayer and all households who have no W-4's on file with payor

Line 5 Multiply Times Proportional Tax Rate

Line 6 Equals Tax Liability

STATEMENT OF SHELDON S. COHEN, PARTNER, COHEN & URETZ, WASHINGTON, DC

Mr. COHEN. Thank you, Mr. Chairman.

I appear before you at your invitation, and these are my own views, not those of any organization of which I am a member.

I would like to quote Edmund Burke, who was a great friend of the American colonist. He said in a very succinct way, "To tax and to please, no more than to love and be wise, is not given to man." We have been going at this for hundreds of years without great success.

We have a complex system, but we have a complex society. You can not have—I agree with Mr. Storrer in that respect—a system which is both fair and simple. Equity does require complexity. You need careful draftsmanship to make sure that the system isn't abused, and that therefore increases the complexity.

Now, in a complex society, as I said earlier, I don't think you can have simplicity. We would not tolerate a Model T or a Model A Ford any longer. A self-starter is required. You could not get anyone not to expect one in his automobile. There are a variety of things in our automobiles today; each one of them adds to complexity; each one of them adds to repair difficulties. And yet, we have grown accustomed to them.

We cannot just hope for a simple system; we have to have the discipline to accept some rigors.

I agree that we could have a simpler system on the day that the Congress would have the discipline to say no to a worthy, deserving case. I would not like to be the Congressman who said no to that worthy, deserving case. However each case has to be weighed in terms of what does it do to society, because each exemption—for example, the one that the NAM was talking about earlier in regard to R&D—each of those exemptions and deductions has to be read by everyone. We have a mass income tax. The provision might apply to me. And therefore, even though it might not, it has to be on the return and in the instruction and I have to read it

We also have a complex society in that businesses are sometimes incorporated, sometimes not, sometimes partnerships, proprietorship or whatever, so we have to have a variety of forms.

We do have a simple tax system now for 65 percent of our population. It's called 1040A. It has a standard deduction; they fill in just a few lines. And indeed if the taxpayer does not want to, he does not even have to compute the tax; the Revenue Service will send him a bill.

So we are talking, you see, only about a third of the population that is affected by the deductions, credits, etc.

I want to disabuse the committee, I hope, of the idea that lowering tax rates and making a return simple will bring compliance. It will not. Zero is a better rate than anything you will come up with. And people will comply with the law to the extent they believe the law is enforced.

There, I will use a simple illustration. I drive out I-270 to my summer home west of here. To the extent that there are Maryland State Troopers evident or radar traps evident, the traffic will move between 50 and 55 miles an hour. If the Maryland State Troopers

were to abandon that strip of highway for several weeks, the traffic moves up to 60 or 65, or even 70. We put constraints into our society to protect ourselves from ourselves. Locks are put on windows not to protect against thieves but to protect honest men from becoming thieves—a thief knows how to break the lock.

Senator GRASSLEY. Do you accept the premise that high marginal tax rates contribute to the underground economy, or complexity of the system or a high marginal tax rate encourages people to, even though they file a tax form, maybe not be as honest as they otherwise would be?

Mr. COHEN. Marginally. To the extent that we don't enforce the law, it doesn't get enforced.

When I had the privilege of managing the Internal Revenue Service, we were running about 5 percent audits. We now have about 1.3 percent of returns audited. Do you think that has something to do with people's propensity to pay? I think it does. I think that we were running about $2 billion in uncollectible accounts. Today we have $30 billion in uncollectible accounts. I think that has a great deal to say about people's propensity to pay.

That is, I am willing to pay my share if I realize and understand that my neighbor is paying his. I don't like it, I would like to pay less. And I would also like to get some simplification. I agree. I am not fighting simplification; I am in favor of it. But if you don't have a reasonable amount of enforcement, there is no system that will work. None of these systems are self-enforcing.

Senator GRASSLEY. Is there a relationship, then, between the more complex the Code is then the more people you have to have working for the IRS to enforce it?

Mr. COHEN. Yes, sir.

Senator GRASSLEY. Well, what we have done is not increased personnel enough to keep up with the complexity.

Mr. COHEN. We have a certain amount of that, but we also have not increased personnel, period. We have kept the personnel about flat while population grows at about on the order of 2 to 2.5 percent a year. So if the Revenue Service budget is not increased on that order, compounded, year after year, they can't keep up with the workload. You know, that is just a given.

A flat tax does not create simplicity—that is, rate structure does not create complexity. You can have a most progressive system or a less progressive system; it doesn't have anything to do with complexity, because rates and calculation are picked up off of a schedule. You don't even have to make the calculation; there is a chart that does it for you. It is the question of whether I have to itemize 10 or 20 or whatever the number of deductions, or whether the Revenue Service and the Treasury have to list instructions that I have to wade through, and they have to provide lines for me to put the information on. That creates the complexity. Rate structure is not very complex--regardless whether you favor a progressive tax, which I happen to favor because I believe there is something to marginal utility. I was taught that in school, and I see that in my life every day. A $15,000 a year clerk does not have the ability to pay the same percentage tax as a half-million dollar executive. Every public survey of our citizenry shows that. It's clear.

One could argue the degree of progressively I would agree with that. But there is nothing about progressivity either way that creates complexity. The forms have to be simple—that's true. I am skipping a great deal of material in my statement.

One of the things that we look at quite often is, we say, "Oh, it would be wonderful if we would go to fundamental reform, so we will go to a VAT or a sales tax or some other type of consumption tax." And we therefore then compare that VAT or sales tax or whatever in splendid theoretical isolation with an income tax that has been corrupted by years of the very efforts of interest groups to get their particular point of view.

Well, the interest groups have become much too sophisticated for that. Each one of those interest groups is going to sit here at this table when you begin to consider a VAT and express its point of view. There is no system in Western Europe involving a VAT that is a single-rate structure. There is no system in any progressive democracy in this world that I know of that does not have a group of exemptions or deductions and exclusions. So we are going to go through exactly that same process. You cannot evade it.

The only question then is whether you want to go through that process in terms of a consumption sales tax which might have some inflationary effects, which nobody has described for the moment, or do you have the discipline to do it in an income tax? And that is really a question of the ability of this committee and indeed the Congress to resist the so-called "worthy cause," because you will hear them for any tax.

Senator GRASSLEY. You are done?

Mr. COHEN. I am done. Yes, sir.

Senator GRASSLEY. All right. Thank you very much. I think Mr. Kendrick is next.

[Mr. Cohen's prepared testimony follows:]

SENATE FINANCE COMMITTEE

Subcommittee on Oversight of the Internal Revenue Service

September 17, 1984

TESTIMONY OF SHELDON S. COHEN

Cohen and Uretz
Washington, D.C.

Mr. Chairman and Members of the Subcommittee, you invited me to testify on the economic effects and administrative aspects of the major tax reform ideas being discussed. I appreciate the opportunity to give you my personal views.

The Committee is attempting to evaluate economic and administrative aspects of a variety of tax ideas which are currently being discussed. The major ideas which are being discussed are so-called flat tax, fair tax, fast tax, sales tax, VAT, excises, etc. I would like to discuss with you the administrative aspects of each of these ideas. As a member of the Congressionally chartered National Academy of Public Administration and as a former tax administrator, I have been very interested in the problems of administering our existing tax system as well as any new tax.

As you know, our tax system is complex. On the other hand, you cannot have a tax system which is both fair and simple. Equity requires a certain degree of complexity. A simple system must be arbitrary. The lines must be straight and orderly. Any exception

to insert equity requires careful draftsmanship so that it cannot be abused. And thus we increase complexity.

Put very simply, I don't believe in a complex society, we could maintain a simple system -- even if we could pass one in the first instance. After all, the present system didn't start this way. To keep the simplicity (if it could be obtained in the first place) the Congress would have to be willing to say, "no" to someone with a sympathetic and perhaps deserving case.

I hope we can get to a simpler system and I hope that the Congress could develop the discipline so that it will say "no" rather than to add complexity to the law. But I have to tell you I am somewhat skeptical. If we could all agree on a simpler law, I doubt that we could keep your fellow legislators from introducing this or that change to benefit what they conceive as a worthy cause. Thus, we will move back toward a complicated statute.

There is some equity in having a law which is comprehended by the average citizen. Most of the complications in our tax law do not apply very widely. After all, almost 70% of those who pay an income tax have a simple understandable return -- it is called 1040A or 1040EZ. The problem with that is that they worry that some of the 30% who file itemized returns or business returns are receiving advantages that the average person does not get. This breeds on itself.

However, I want to warn you, that lowering tax rates and making the return simpler will not cure all the ills. The so-called black economy will not disappear because we lower the rates. After all a zero rate is lower than any tax rate being discussed.

We must have adequate audit and collection personnel to do a fair job of enforcing the tax law -- whatever form it takes. We can use the highways as an example. We all know that it takes a reasonable amount of police activity to enforce a 55 mile per hour speed limit. If no police ever appear on I 270 west of Washington, we can all be certain that the automobiles will begin going 60 and 70. If, as now, we see a Maryland State Tropper here and there or a radar trap now and then, the traffic will essentially hold to the legal limit. So it is with the audit level. A few years ago the audit level was approximately 5%. Now it is approximately 1.3%. The underground economy has grown even faster than a multiple of that difference.

Since I have only recently returned from vacation, I did not have time to develop fully my testimony. I have attached an outline of the points I believe need developing. I would be pleased to work with your staff in developing these issues.

OUTLINE OF ISSUES FOR THE COMMITTEE

The best tax has three attributes:

It is administrable

It is simple

It is fair

I. Administrability.

A. IRS and individual taxpayers have very similar problems. They want a tax which is easily administered.

1. Manageability.

a. Agents and taxpayer must be able to understand and apply the law.

b. Audits must be efficient and effective.

2. Collections.

a. People have to be willing and able to pay.

b. Forms must be reasonable (in relation to the tax bracket).

c. The system must be just. It more importantly must be perceived as just.

B. Simplicity.

1. Forms must be simple for majority of taxpayers.

Rate brackets do not affect simplicity -- people use the tax tables. Deductions and credits create complexity.

2. Law should be simple to reduce effort, cost, and uncertainty in determining its application.

a. The special capital gains treatment probably adds more complexity than any other in the code.

b. Distinctions in the law in attempting to do equity cause undue complexity.

C. Fairness.

1. Perceived fairness is necessary for taxpayer compliance.

2. Progressive income tax is generally perceived as fair. While some may quarrel, the great majority of people believe that someone earning $500,000 should pay at a higher rate than someone earning $15,000. There is something to the concept of diminishing marginal utility.

II. How To Get There From Here.

A. Retain a tax on net income.

1. Widely understood and accepted in principle.

2. Broaden the base.

3. Retain progressivity.

4. Alternatives to income tax have serious problems.

a. Consumption tax.

(1) People don't understand it. Difficulty in educating them.

(2) Regressive -- disproportionate benefits to those who can afford to save.

b. VAT.

(1) Administrative difficulties.

(a) IRS has no staff trained to enforce it.

(b) Private industry has no staff.

(c) Most suggest it as an added tax or to replace a portion of the income, or social security tax. Thus we would need added administrative personnel both in IRS and in industry.

(2) Taxpayers don't understand it.

(3) Compliance problems.

(a) No reciprocal incentives not to cheat.

(b) In Europe, no attempt even to collect from small businesses.

(4) No simpler than income tax -- subject to same political pressures toward complexity. No country has enacted a VAT with no exceptions. Each exception creates complexity.

(5) Supplementary VAT doubles the problems.

c. Flat Tax.

(1) Fairness requires progressivity.

(2) Elimination of progressivity doesn't simplify.

B. Congressional Discipline.

1. Fine distinctions drawn to the effort to achieve equity cause complexity in the tax law.

2. Simplicity is an important and worthy goal.

STATEMENT OF JOHN W. KENDRICK, PH.D., PROFESSOR OF ECONOMICS, GEORGE WASHINGTON UNIVERSITY, WASHINGTON, DC

Mr. KENDRICK. Mr. Chairman, I appreciate your invitation to express my personal views on possible tax reform. As a specialist in productivity and economic growth I am particularly interested in the U.S. tax system from the viewpoint of its impact on saving, investment, growth of capital, and thus growth of output and real income per capita.

An important aspect of productivity growth is the growth of capital per worker, and one of the reasons for the productivity slowdown for a decade after 1974 was a slower growth of real capital—plants, equipment—not to mention the intangible capital—research and development, and education—per worker.

One reason why many economists do not like an income-based tax system is that it basically represents a double taxation of saving, as I explain in my paper. Further, in our existing income tax system, there is a misallocation of capital among competing uses, since tax rates on investments differ widely from one investment to another, all the way from 90 percent on certain kinds of investment down to a negative number on other types of investments, due to unrealistic depreciation allowances, investment tax credits, and particularly the effect of inflation on estimated depreciation allowances.

A third reason why our system is not very facilitating for productivity growth is its complexity, so that energies are diverted from increasing productive efficiency to minimizing tax liabilities.

The need for fundamental tax reform, which you mentioned in your introductory remarks, was underscored in the reports of two bodies whose work has not received much attention. But last year

we had a National Productivity Advisory Committee which reported in December, which recommended basic tax reform. And then last September there was a White House Conference on Productivity, and that report issued this past spring likewise recommended fundamental tax reform which would be more favorable to saving and investment and also not distort investment decisions.

In that direction there are a number of consumption-based tax systems, all of which are equivalent. One is the tax on consumed income, known as a cashflow expenditure tax, in which verifiable saving is excluded from income before the tax. This is equivalent to taxation of a base that would exclude property income flows; and you can get the same effect by indirect taxation on consumption by a comprehensive national sales tax or a value-added tax.

I think any of these approaches would be an improvement over our present income-based tax system. I worry a bit about getting all of the revenue from a national sales tax or a value-added tax because of regressivity, and once you exempt a lot of necessities the tax base is reduced, so that probably these taxes would have to be considered as an add-on or a supplement to income tax reform, which might reduce its revenue-producing ability.

Of the other two, Congressman Heftel has a proposal for a cashflow expenditure tax in which saving is subtracted before estimating the tax; however, it is rather steeply progressive, going from 10 to 50 percent, and I think that the proposal of the Brookings Institution, reported in its volume "Economic Choices—1984", is better in that there are just three steps, ranging, as I recall, from 5 to 32 percent, which sounds more reasonable.

The DeConcini proposal for a flat-rate tax whereby property income would be exempted is also a good possibility; however, I have some problem with the flat rate tax because I tend to agree with Mr. Cohen that some progressivity in the tax system is desirable from the viewpoint of equity. But that could obviously be remedied, and probably once the various proposals get reconciled we will have some sort of consensus about the degree of progressivity which would be desirable from the viewpoint of Congress' perception of equity in the tax system.

The other possibility, of course, is to try to reform the existing income tax system, and I think the bills now before Congress are desirable from various points of view—that is, Bradley-Gephart, Kemp-Kasten, Quayle, and so on—in reducing exemptions, deductions, exclusions, and thus, by increasing the base, reducing the tax rate. I think that is all to the good.

I would propose a few additional reforms that are not in most of these bills we now have. One is, I would like to see more exclusion of dividends and other types of property income in order further to stimulate saving. I would like to see more indexing for inflation—certainly indexing of tax brackets and exemptions—and probably indexing of capital gains; that is, you only pay a capital gain if your property has gone up more in value than the CPI since the time you bought it.

Senator GRASSLEY. Do you need more time to proceed?

Mr. KENDRICK. Just very little.

I would like to see the R&D tax credit extended, if not possibly a subsidy on R&D, particularly by capital goods manufacturers,

which would help bring down the price of capital goods and stimulate investments.

In conclusion, let me just refer to an article I had on the editorial page of the Wall Street Journal on August 29. There, basically, I assume that there will be tax reform next year, as many people are predicting, and "that the tax simplification and reform succeeds in shifting more of the tax burden toward the consumed portion of income." If that happens, I think we can remain on the higher productivity trend that we have been on now for the last couple of years. I think that this can continue throughout this decade. It will mean a slower increase in costs—cost per unit of output. It will mean less inflation—I would think no more than 4 percent or so for the rest of the decade, which is far better than the double digit we had just a few years ago. And this of course will mean a lot of saving in the budget, because interest rates will tend to come down further if we have less inflation, and that of course will help the deficit situation.

So I do hope we move toward fundamental reform in 1985.

Senator GRASSLEY. Thank you, Mr. Kendrick.

Mr. Bradford?

[Mr. Kendrick's prepared testimony follows:]

Testimony of John W. Kendrick, American Enterprise Institute and The George Wasnington University, before the Sybcommittee on Oversight of the Internal Revenue Service of the Senate Finance Committee, Senator Charles E. Grassley, Chairman, September 17, 1984.

The present U. S. tax system has been characterized as a "crazy-quilt" which is "riddled with special provisions that affect taxpayers in similar circumstances very differently and needlessly reduces economic efficiency."[1]

Since the problems of the system have been documented extensively, I may summarize them briefly.

Indictments of the Present Tax System

Most important from the viewpoint of effects on productivity and growth, an income-based tax system involves double taxation of saving. This is true since the income out of which saving is made is taxed, and so is the income from the investments into which savings flow. To look at it another way, taxes on property income drive a wedge between the social (before tax) rate of return on investment, and the private (after-tax) rate of return. As a result, there is too little saving and investment and therefore a lower rate of economic growth than is socially optimal.

Further, there is misallocation of capital among competing uses since tax rates on investments differ widely from one type to another. This is due to unrealistic depreciation allowances; the effects of inflation on depreciation and some other cost calculations; investment tax credits; double taxation of corporate equity income while income from owner-occupied housing and municipal bonds is excluded; and asymmetrical treatment of capital gains and losses. The resulting diversion of investment from the most

productive uses reduces economic growth. Saving patterns are also affected since some types of saving are sheltered while others are not.

Labor compensation is also distorted in that some types of compensation, such as certain employer-financed fringe benefits as well as some transfer payments, are not taxed. Various other exclusions mean that tax rates are higher than they would otherwise be, which serves to penalize work.

Finally, the Federal tax system has become very complex, resulting in complicated tax-avoidance manipulations. Thus, energies are diverted from increasing productive efficiency to minimizing tax liabilities. Individuals lacking the knowledge or resources to do so are penalized by paying more than their fair share of taxes.

The need for fundamental tax reform as a major means for promoting the growth of productivity and per capita real income was recognized by both the National Productivity Advisory Committee and the White House Conference on Productivity in their reports to the President during the past year. The Committee's Recommendation 2 was: "Replace the current income tax with a system that would tax all incomes just once at rates not exceeding some low fixed rate and provide for immediate expensing of all investment expenditures." [2]

The White House Productivity Conference Report recommended: "The President and the Congress should resist making further piecemeal changes in our tax laws and develop a specific plan for fundamental tax reform." It was specified that the reform should "achieve neutrality in effects on saving and investment decisions."[3]

Consumption-based Taxes

There are several types of reform proposals that would eliminate the double taxation of saving. One is the consumed income tax, also known as a cash flow expenditure tax. The tax base comprises all monetary receipts minus verifiable saving, investment and debt repayment. This is equivalent to taxation of a base that would exclude property income flows. The same result could be accomplished by an indirect tax on consumption expenditures, such as a value-added tax (VAT) or a comprehensive national sales tax.

With respect to VAT or sales taxes, a major objection is that they are regressive. They would also interfere with state and local government revenue sources, and would increase consumer prices. Exemption of necessities in order to make the indirect taxes more equitable and possibly proportional would reduce the revenue base. In practice, a VAT or selective national sales tax would be relevant as an add-on to supplement the revenues obtained from a reformed income tax or other sources.

Proposals for a consumed income or cash flow expenditure tax have been developed in some detail by Brookings Institution economists.[4] A similar approach is embodied in a bill "The Progressive Consumption Tax" (H.R. 5841) introduced by Representative Cecil Heftel, which would substitute the expenditure tax for the current income tax. The rate structure ranges from 10 to 50 percent. The progression is considerably steeper than that in the Brookings proposal, which ranges from 5 to 32 percent for incomes in excess of personal exemptions. The Heftel bill would replace the current corporate income tax with a 30% tax on corporate dividend payments.

The Brookings economists would tax the cash flow of corporations at the maximum rate on personal cash flow. The corporation tax base would include total receipts (except proceeds from the sale of stock) less all business expenses including investment.

Exclusion of capital income rather than saving is provided for in "The Flat Rate Tax Act" (S. 557) introduced by Senator Dennis DeConcini. It taxes both individual and corporate income at a 19 percent rate. Most of the tax credits, deductions and exclusions of the current income tax are eliminated or modified. The personal exemption is indexed for inflation. "The Flat Rate Tax Act" is virtually identical to the proposal of Drs. Robert Hall and Alvin Rubushka of the Hoover Institution.

The details of any bill under serious consideration to substitute a consumption-based tax for the present income tax would have to be examined carefully, of course, and extensive hearings held. Here I offer a few general comments. Any flat rate tax would be criticized on equity grounds. But even a progressive tax on consumed income would be subject to the criticism that it would promote the concentration of wealth. After all, saving and wealth confer economic power, security, and opportunity, even though it is only consumption that creates direct utility. Inclusion of gifts and bequests in the cash flow tax would help meet that objection, although there would be much debate over the appropriate level of exemptions. There would also be a difficult transitional problem in taxing consumption expenditures out of income that had previously been taxed. The Brookings study suggests ways of handling that.

If capital income rather than saving were excluded from the tax base, as in the DeConcini bill, there would be large windfall capital gains to owners of securities and some other types of property. This problem could

be addressed through capital gains taxation, and gift and estate taxation designed to moderate inequalities of wealth.

Cash flow expenditure taxation would create new book-keeping and administrative problems with regard to qualified channels of saving. But its proponents claim that overall complexity would be reduced in comparison with the present income tax.

It is my judgment that the advantages of expenditure taxation would decisively outweigh the disadvantages. Since it is neutral with respect to the consumption /saving decision, saving and investment would be increased, promoting growth of productivity and real income. Exclusion of investment would eliminate the distortions introduced by depreciation accounting, especially in inflationary periods. With a zero effective marginal tax rate on all assets, investments would flow into their most productive uses.[5]

Income Tax Reform

There are more than a dozen bills pending in Congress proposing reform of the Federal income tax system. Perhaps best known are "The Fair Tax Act of 1983" (S. 1472, H.R. 3271) introduced by Senator Bill Bradley and Representative Richard Gephardt, and the Kemp-Kasten "Fair and Simple Tax Act" (S. 2600 and H.R. 5533). These bills generally broaden the income tax base by eliminating or limiting many of the special provisions for both individuals and corporations in current law. As a consequence, tax rates are reduced significantly. The rates are progressive in some of the bills, and flat in others.

The base-broadening and rate reductions are all to the good, since they would reduce the distortions in the present system referred to earlier.

I would only suggest some additional reforms that would further encourage saving and more efficient business investment decisions.

First of all, I recommend expanding the allowed deduction for corporate dividends, making it 100 percent if revenue considerations permit, in order to eliminate the double taxation. Interest deductions for interest receipts should also be expanded and/or indexed for inflation. Revenue loss could be made up by not permitting interest payments as a deduction, which would put equity and debt financing on an equal basis.

Expensing investment outlays, or the present value of future economic depreciation, would be a great improvement over arbitrary capital recovery allowance. As noted above, this would reduce tax-related distortions of investment decisions. It would also be desirable to allow unlimited loss carry-forwards, including interest on the losses until they can be offset against profits.

Indexation of income tax exemptions and brackets for inflation should not be scrapped, although it might be delayed or limited temporarily due to revenue requirements. Indexing for inflation should also be applied to capital gains, and possibly to taxable interest receipts.

A modified research and development tax credit should be extended beyond 1985. If it were dropped, consideration should be given to R&D subsidies in view of the external benefits of R&D and its importance to technological innovation.

Conclusion

In conclusion, I strongly support the replacement of the present income tax system with a cash flow expenditure tax. This would not only increase

saving and investment; it would also improve efficiency in the allocation of capital; and, hopefully, result in a less complex tax system. All of these benefits would conduce to a stronger growth in productivity, real product and income per capita. With such reforms, as I pointed out in an article in the August 29, 1984, Wall Street Journal (copy attached for the record), productivity growth in the years ahead should resume its long-term trend. This would be a crucial element in holding down cost and price inflation, which, in turn, will help to reduce interest rates and the Federal deficit.

FOOTNOTES

1 Alice M. Rivlin, Ed., Economic Choices 1984 (Washington: The Brookings Institution, 1984), Chapter 2, "Reforming the Tax System," p. 37. Henry Aaron and Harvey Galper were primarily responsible for preparing this chapter.

2 National Productivity Advisory Committee, Restoring Productivity Growth in America: A Challenge for the 1980s. A Report to the President of the United States and the Secretary of the Treasury, December 1983, p. 6.

3 White House Conference on Productivity, Productivity Growth: A Better Life for America. A Report to The President of the United States, April 1984, pp. 7-8.

4 Rivlin, op. cit. See also Barry P. Bosworth, Tax Incentives and Economic Growth (Washington: The Brookings Institution, 1984), especially Chapter 6, "Implications for Economic Policy," pp. 177-203.

5 See Charles R. Hulten, "Taxation: Our Defacto Industrial Policy." Testimony Presented to the President's Commission on Industrial Competitiveness. (Washington: The Urban Institute, July 10, 1984), p. 11.

THE WALL STREET JOURNAL.

WEDNESDAY, AUGUST 29, 1984

Productivity Gains Will Continue

By JOHN W. KENDRICK

This week's news that non-farm productivity grew at the surprising annual rate of 4.7% in the second quarter of 1984 has encouraged some observers to believe that the cyclical recovery in productivity is virtually over. Now that capacity utilization is close to normal, they expect productivity gains to almost evaporate. I believe instead that productivity will have an upward trend for at least the rest of this decade.

The pessimists base their view on our record during the decade prior to 1983, when the average annual growth in productivity was less than 1%. Since mid-1982, I not only have argued that we would see a strong recovery in real gross national product and productivity, but also stated that the 1970s slump in productivity was over. If this is correct, we can look forward to relatively strong economic growth through the 1980s with only moderate increases in the general price level.

Since the recovery began in the last quarter of 1982, productivity growth has averaged 3.3% annually. While a bit less than the average of prior recoveries, this growth rate has been at least double that projected by most forecasters. Over the same period, the increase in average hourly labor compensation decelerated to less than 4% annually—to the surprise of almost everyone. As a result, labor costs per unit of output have risen by less than 1%, permitting a strong upsurge of profits that continues to fuel the recovery.

Negative Factors Reversed

Most of the factors that had a negative impact on productivity growth in the 1970s have been reversed. The post-World War II baby boomers, who swelled the ranks of inexperienced youthful workers in the late 1960s and the 1970s, are now passing into their prime working years. The costs of complying with social regulations have begun to level out as a percentage of GNP after major increases in the 1970s. The drive to rationalize anti-pollution and health-and-safety regulations, which began under President Carter, has continued under President Reagan. The same is true of the move toward economic deregulation that has lowered prices in portions of the utility, transportation, communications and finance sectors, and increased competitive incentives for higher productivity.

Even more important has been the deceleration in the general inflation rate, and the decline in energy prices since 1981. The acceleration of inflation during the 1970s, exacerbated by the oil shocks of 1973 and 1979, is widely credited with a major role in the productivity slowdown. Inflation eroded profits and reduced investment incentives. It impaired the efficacy of the market pricing system as an allocator of resources, and diverted managerial energies from increasing efficiency. The huge increase in energy prices rendered some energy intensive equipment obsolete and fostered substitution of less-expensive, lower-productivity technologies.

The opposite is now true with these factors. In particular, the deceleration of inflation has increased the value of reported profits, helping to explain the bull market that began in August 1982 and the subsequent revival of investment. It also helped to offset the effect on investment of high interest rates. Although down from their peaks, long-term interest rates have yet to reflect the marked drop of inflation. This is generally ascribed to doubts that inflation will remain subdued, although the general upward trend in bond prices since early June suggests that financial markets are now more confident that inflation will not soon return to double digits.

The chief long-term factor driving up productivity growth is technological advancement, largely through research and development. From a peak of almost 3% of GNP in the mid-1960s, R&D sagged to a low of 2.2% in 1977. Since then, both public and private R&D spending has risen, and is now 2.6% of GNP. Even after allowance for lags, this surge is contributing to an increase in the flow of cost-reducing inventions and innovations. Congress is likely to make the incremental R&D tax credit enacted in 1981 permanent, with some revisions, before it expires in 1985. This would add additional stimulus to technological progress in the years ahead.

Most of the factors that lowered productivity growth during the 1970s have been reversed.

Since most productivity-raising innovations are embodied in capital goods, the current investment boom is encouraging. Over the past year, real nonresidential building and equipment expenditures have risen by more than 22%. In addition to the favorable effects of lowered inflation, the net effect of the tax acts of 1981 and 1982 has been to significantly increase the after-tax rate of return on investment. An Urban Institute stuuy estimated that the inarginal corporate tax rate on income from new fixed investment has dropped from the 32.8% average of 1973-81 to 15.8% currently. If the tax simplification and reform considered likely in 1985 succeeds in shifting more of the tax burden toward the consumed portion of income, the additional stimulus to saving and investment will prolong the expansion.

There have been favorable developments in labor-management relations in the past several years as a result of keen foreign competition and the recessions. Not only have nominal wage-rate increases moderated significantly, but many new union contracts have reduced or eliminated restrictive work rules. Both union and non-union workers increasingly have participated in quality circles and other joint labor-management team efforts to improve productivity. These programs seem to be having a positive impact on efficiency. To the extent that they elicit innovative ideas from workers, they promote productivity in the long term.

Through the use of a growth-accounting model, I have tried to roughly quantify what the effects of these developments will be on productivity growth between 1984 and 1990. It comes out at about a 2.5% average annual rate of increase, close to the long-run trend. It is below the 3.2% rate of the first two decades after World War II, which was influenced by the needed rebuilding of industrial plants. But it represents a healthy comeback from the slowdown to 0.8 % between 1973 and 1981. Combined with projected increases in labor force, employment and hours worked, it means an overall real growth rate of about 4% a year, compared with 2.2% in the earlier period. This gives an added kicker to productivity growth from greater economies of scale, and more efficient rates of plant-capacity utilization—even assuming a 6% unemployment rate in 1990 compared with today's 7.5% rate.

Unit labor costs are determined by average hourly compensation as well as productivity. Wage increases have decelerated from a 9.5% annual increase in the short-lived 1980-81 recovery to a 4% annual rate in this one. The continuing outlook is good. The Council of Economic Advisers reports that when the unemployment rate is above 6.5% it exerts a downward pressure on wage increases. During the first half of 1984, major collective-bargaining contracts resulted in adjustments averaging only 2.8% annually over the life of the contract, no higher than in 1983.

Even below the 6.5% rate cited by the CEA, it takes some years for rising demand and falling supply of labor to ratchet up wage increases much. The old saying "wages lag" is reinforced by the prevalence of multiyear union contracts. The low inflation rate also will help hold down wage increases, as will continuing foreign competition.

Projection of 1984-90 Average

If we assume a gradual acceleration in wage increases after 1985, a reasonable projection for the 1984-90 average is 5.5%, close to the 1948-73 average. Given my forecast of a 2.5% average gain in productivity, the upward trend in labor costs per unit of output would be held to 3%. Even allowing for some further recovery in profit margins and faster increases in prices of imported goods as the dollar declines in value, it would be surprising if the implicit price deflator rose by as much as 5% a year, on average.

All this assumes that the Federal Reserve Board will hew to a restrained monetary policy. If by 1986 wage increases are accelerating and productivity gains are lagging, as is typical of the latter phase of economic expansions, I would expect the Fed to continue current policies so that higher labor costs would not be fully reflected in price increases. The ensuing profit squeeze and probable recession would serve to bring wage and price inflation back in line with the modest rate that the public, the government and the Federal Reserve seem willing to tolerate.

Those who are pessimistic concerning the productivity and inflation outlook are likely to find that the 1980s will turn out quite unlike the 1970s. Many current forecasters implicitly assume that we face a reprise of the 1970s, with decelerating productivity and accelerating inflation. It is both my expectation and hope that they will be proved wrong.

Mr. Kendrick is a professor of economics at George Washington University, and adjunct scholar at the American Enterprise Institute. He is co-author of "Productivity in the United States" (Johns Hopkins, 1980).

STATEMENT BY DAVID F. BRADFORD, PH.D., WOODROW WILSON SCHOOL, PRINCETON UNIVERSITY, PRINCETON, NJ

Mr. BRADFORD. Thank you, Senator Grassley. I appreciate the chance to speak to you today on this subject. I am very interested in what my fellow panelists have been saying.

I should say, about my own remarks, that they are in rather simplified terms. I think that anyone who gets into this subject at all deeply realizes that slogans are always going to be misleading and that the best we can do is to try to convey a few basic ideas with them.

I am under no illusions that even the sorts of general reforms that I advocate could be accomplished in such a neat and clean way as I am about to suggest maybe they could.

Also, I think all of us who worry about reform need to keep in view the many ways in which the tax system influences our lives. Mr. Storrer spoke of the need to clean up the tax system so that it isn't a regulator of our society; but at the same time we do have to reflect on the degree to which the present composition of our society in many, many ways is in fact strongly influenced by the tax system. I need hardly mention home ownership, the relative employment of husbands and wives, the extent of charitable activities, the way families manage inheritances, the forms in which we conduct our business,—corporations and partnerships, and so on. Our lives are extraordinarily strongly influenced by the tax system, and major changes would therefore need to be made with due sensitivity to that fact.

Now let me go back to an oversimplified discussion perhaps of a subject which is close to my interest, which is the virtue of shifting the basis of taxation to what I call "consumed income."

A tax on consumed income conjures up various images in the minds of both its opponents and its advocates. I am an advocate, and to me a tax based on consumption promises a fairer distribution of the tax burden, a vastly simpler tax law, and a much improved use of our nation's resources.

Let me then try very briefly to accomplish three broad things: One, explain what I mean by a consumption based tax; two, summarize some of the main arguments, again in simplified form, for such a tax; and, three, given an illustration of one way in which we can convert the existing income tax system into one on a consistent consumed income basis.

It is important to recognize, I think—and a lot of discussion ignores this—that what we now have isn't an income tax, at least in the sense that theorists have come to discuss the term, which has to do with the way in which people accrue wealth and consumption during a year. Right now what a family takes in during the year can be applied to three uses—to consumption, to saving, and to certain other things which sometimes get described as "costs of earning a living," but also such things as State income taxes and medical expenses, which some would regard as neither consumption nor savings.

What the tax technicians traditionally mean by "income" is what is left over after subtracting those other things, so it is a sum of consumption and savings, and it is in the treatment of savings

that the present system is just wildly inconsistent. Let me give you some examples: Under the existing rules some forms of savings are grossly overtaxed. This was really dramatically clear when we had inflation running at 12 percent with interest rates in the money market at something like 16 percent. A person who wasn't taxed at all would be getting a net real return on lending of 4 percent—16 percent nominal interest less 12 percent inflation caused erosion of the value of the money. That is fine, but a person who was wealthy enough or with a high enough salary to be in the 50-percent bracket would have paid 8 percent in taxes, leading to an 8-percent after tax return on that money market fund. But with inflation going at 12 percent, that would mean his money was losing value at 4 percent a year—a negative after-tax rate of return—obviously setting up a strong disincentive for accumulating in that form. And naturally what happened was that high-bracket taxpayers got out of those assets and got into more interesting lines such as real estate or Chinese vases, or any of several other ways that we have of holding wealth that suffered less of a tax disadvantage.

Such inconsistent treatment of saved income leads to inefficient investment, and it's at the heart of the manipulations by which people perceive well-to-do people as reducing their tax liability and avoiding their fair share. It is also the main culprit, I would argue, in the complexities of the law. It is obviously not the only one, but the main one.

Some people argue, and it is a very traditional argument, that what we should do is fix the system by going after accrual income by a proper system of accounts. For example, we could measure and tax capital gains not on realization but as they accrue. We could tax the value of a person's pension claim as it grows over time, and so on. I think that is a bad idea. I don't think anyone is seriously going after that, either.

Well, if we go the other way and simply exclude savings from the tax base, which is what I think we ought to do, we would be left essentially with consumption as the base.

Now, the critical point is that what I have just described could certainly look like an income tax, and that's why I call it a "consumed income tax," and certainly it would deserve to be called an income tax as much as our present system is. So anybody who says that it would be dramatically moving away from what we are now doing is simply incorrect.

Let me turn then to a few of my ideas. Actually, I see I am going to run right out of time.

Senator GRASSLEY. No, you go ahead.

Mr. BRADFORD. Shall I go ahead?

Senator GRASSLEY. Yes.

Mr. BRADFORD. Well, let me turn to just a few of my ideas on why this would be a good idea.

The most important reason in my mind for basing the tax on consumption is that it would be fairer. People are often surprised by that, but I think it is probably because they haven't really thought enough about it.

Consider two families that are similarly endowed with basic earning power—they can be either large or small, well-to-do or less so—but who differ in their savings behavior. Would we want to

treat those two families differently for tax reasons, impose different tax burdens on them? In particular, would we want to impose a higher burden on the family who decides to, or just happens to, save more than the one who saves less—for whatever reason?

It seems to me if there is an argument on that subject it would go the other way. There is sort of a social virtue to saving. We all benefit if our neighbors are prepared to finance their own children's education and pay their own medical bills, and so forth. I would not exaggerate this social value of saving. But I certainly don't understand the argument that the tax bias should go the other way, that we should penalize the person who saves more. It seems to me that the case in fairness almost opens and closes with that remark, and the task of the tax policy designer is to find a way which imposes burdens in the way that we want, progressively related to people's basic resources, but which doesn't within that progressivity penalize those who decide to save more rather than less.

That then brings us to the question of progressivity. We know that well-to-do people are those who do a lot of the saving—certainly that is the traditional finding in economics. Does that mean we can't have a progressive tax? It seems to me the answer to that is No.

For one thing, in designing a tax you should take into account that you can't take your money with you. The Brookings plan that was mentioned today is very clever about taking advantage of that, so that even people who save a great deal eventually either have to give it away or consume it. So depending on how you treat those transactions, you could tax them on that.

Second, we would get a great deal of progressivity, I think, if we just applied the existing tax structure to a consumption base. It would be still quite progressive even by current standards, and it is possible that one could change the rates and make it more progressive, if that is what one wanted to do.

Now let me turn very briefly—and I will try to be very quick on this—to the point that the consumption basis provides a proper treatment of investment and therefore will enhance the efficiency with whish we use our resources.

The characteristic of our tax law is not the heavy tax on the use of savings and capital but the very varied tax on such uses. Mr. Kendrick was very clear on that point. A close study of the subject just leaves one's mind boggled with the incredible variance of the taxation of capital. But when that happens, you have capital moving from heavily taxed to lightly taxed uses, and that doesn't do anybody any good; it is just a net waste; it is like throwing some of our capital in the ocean. And in my opinion there is no practical way, even if we wanted to, to tax all of that yield consistently on the basis of income principles; whereas consumption approaches in fact lead to a very, very simple way to tax it all uniformly, namely at zero. I have argued I think that is a good idea on its own merits.

Well, these consumption rules—would they require a vastly new set of institutions? Do you have to make a radical change in the tax system?

I think the answer is "not necessarily," although some would argue that that is exactly what we need. An instance is the Hall-

Rabushka simple flat tax, the DeConcini bill, which is a fairly radical change in the system, and that is a tax that is based on consumption. Now, I think it is a very attractive tax in many ways, but in our political process it is likely that people are going to want in the end a less radical change, and the question is could we implement the consumption approach in the context of less sweeping changes in the law? And I think the answer is, very clearly, we could.

So I will just tick off a 6-point program by which we could convert the existing tax system to one based on consumed income.

First of all, we would want to extend the IRA principle. Phase out restrictions on deposits to and withdrawal from Individual Retirement Accounts and similar things such as employer-provided retirment plans, Keogh plans, and the like. Deposits to those institutions are deducted from the tax base and all the withdrawals are included.

Second, we would phase out over some appropriate period of time the taxation of interest, dividends, and capital gains. Now, that is a radical step, but for example if we look at interest overall in the economy, the taxation or interest yields a loss of revenue now, deducted by higher bracket taxpayers than included.

Third, accelerate depreciation allowances until we have first-year writeoff of all capital outlays, and do the same with inventory. That vastly simplifies the treatment of investment in the tax system.

Fourth, a technical point, allow people to borrow from their tax-qualified plans, with the borrowing taken into income and the payments deducted.

Fifth, phase out all the ad hoc savings and investment incentives that we now have, most importantly the investment credit.

And sixth—and this is very important—phase out the deduction for interest paid. I spoke about phasing out the inclusion of interest received. You would of course want to treat that in a symetric way and phase out the deduction for interest paid.

Well, these sorts of things are not unheard of in our tax reforms of recent years. We do exactly this kind of thing—we accelerate depreciation, we play with the taxation of interest, and so on. I don't think they are totally radical, and they could be done over a period of time. It would convert our system to a quite consistent consumed income basis.

All the other sorts of base-broadening things one talks about, whether it is a change in the charitable deduction or whatever, would be quite consistent with the same approach.

That completes my remarks. Thank you.

[Mr. Bradford's prepared testimony follows:]

Testimony before the Sub-Committee
on Oversight of the Internal Revenue
Service of the Senate Finance
Committee,
Washington, D.C., September 17, 1984.

Statement of David F. Bradford

Professor of Economics and Public Affairs, Princeton University,
and
Director of the Research Program in Taxation
National Bureau of Economic Research

Mr. Chairman and members of this distinguished Committee, my name is David Bradford. I am Professor of Economics and Public Affairs at Princeton University, where I specialize in Public Finance, and Research Associate of the National Bureau of Economic Research, for which I direct a program of Research in taxation. During 1975-1976, I served as Deputy Assistant Secretary of the Treasury for Tax Policy. I am most grateful for the invitation to present my views today on the possible advantages of shifting our tax system toward one based on consumed income.

A tax on consumption conjures up various images in the minds of both opponents and advocates. I am an advocate, and to me a tax based on consumption--better described as a tax on consumed income--promises a fair distribution of the tax burden, a vastly simpler tax law, and a much improved use of the nation's savings. In my few minutes I shall try to accomplish three things: (1) explain what is meant by a consumption-based tax, (2) summarize some of the main arguments for such a tax, including those relating to the productivity question, and (3) give an illustration of concrete steps that would convert our tax system to a consumption base.

Actually, the U.S. income tax isn't really based on income in the first place. What a family takes in during the year can be applied to three uses: to consumption, to saving, and to certain other expenses, such as union dues, state income taxes, and the like, which are neither consumption nor savings. What tax experts mean by income is what is left after subtracting those "other expenses" from what comes in; in other words, the sum of saving and consumption. It is in the treatment of saving that the present system is confused to the point of perversity.

Under existing rules, some forms of saving are grossly over-taxed, others are under-taxed. When inflation was running at 12 percent, for example, a money market fund might have yielded 16 percent. This provided a reasonable 4 percent "real" return for a person or institution not subject to tax. But someone fortunate enough to be in the 50 percent bracket would have paid 8 percent in taxes, leaving a real return of

negative 4 percent after taxes. Naturally, high-bracket taxpayers got out of assets that were over-taxed to them, and into under-taxed ones, such as real estate or Chinese vases.

The inconsistent treatment of saved income leads to inefficient investment. It is at the heart of the manipulations by which rich people reduce their tax liability. And our muddled approach to taxing savings is the main culprit in the staggering complexity of the tax law.

Some would argue that the best way to fix this problem would be to go after the lightly taxed returns to savings--by taxing capital gains in full as they accrue, for example, or by including the earnings of pension funds in the income of workers. I think this is a bad idea. A much better idea would be simply to exclude savings from tax.

Excluding savings leaves consumption at the taxable base. This is the critical point. The resulting tax would look like an income tax, which is why I referred to it above as a consumed-income tax. Certainly such a tax would deserve to be called an income tax at least as much as our current system deserves it. It just excludes one more item from the base--but one that should be excluded.

Let me turn then to some of the reasons it would be a good idea to exclude savings from tax, and to some of the concerns often expressed about such a policy.

The most important justification for basing tax on consumption--and I put it first for that reason--is that it would provide a more equitable distribution of the tax burden. Those accustomed to regarding an income tax as the fairest tax are often surprised by this, but I suspect that is usually because they haven't thought enough about it. Consider first the question of how we should treat two families that are similarly endowed with basic earning power--be it large or small--but who differ in their saving behavior. If the family next door, with the same earning power as mine, puts aside funds for future use (for educational expenses, retirement consumption, reserve against medical emergency, or whatever), while my family does not, should their tax burden be higher than ours? The notion seems absurd, yet that is the consequence of taxing savings. Perhaps the family that saves should be rewarded--their children will be more likely to pay their own way in college; they will pay their own medical bills; and in general they are less likely to have to call upon others when confronted by temporary emergencies. But whatever the merits of this line of thought, surely we don't ordinarily reward the prodigal son. The family deciding to save less should not thereby incur a lesser tax burden than the family that saves more. By excluding savings from tax we achieve the result that the two families bear the same burden.

Many, perhaps most, would accept this argument, but object that it overlooks the fact that high earners are also observed to be high savers. Won't a tax based on consumption be regressive? This concern is not warranted because it is based on a misapprehension. You can't take your savings with you. What is taken in must ultimately go out, as consumption, as "other expenditures," as gifts or as bequests. Even if gifts and bequests were excluded from the donor's tax (and included in

the tax of the recipient), and even without base-broadening reforms, applying rates similar to today's to a base that excluded savings (but included dissavings) would result in considerable progressivity. But, in any case, if more progressivity were desired, it could be had by adjusting the schedule of rates.

Won't a consumption base shift taxes away from the middle aged and toward the young and old? The question is badly posed. The right way to measure tax burdens is to do so over an extended period of time. Each individual is young once, middle aged once, and old once. The important issue is how average burdens over the life cycle compare with a family's ability to pay.

What about the changeover? Wont't a shift to a consumption basis for taxation unfairly subject existing savers to a second round of taxes on the money they have put aside? Not necessarily. As with any substantial change in the tax system, an immediate shift to a consumed-income base would cause redistributions of wealth that are not desirable in themselves. However, rules can be designed to avoid unfair double-taxation. The specific example I shall offer shortly illustrates this important point.

What does all this have to do with productivity? The present tax system causes a serious waste of resources. The effective burden of tax on investment in productive capital, by businesses and households, varies enormously. As a consequence, too much is devoted to lightly taxed forms of investment, and too little to heavily taxed forms. Simply by reallocating our existing savings we could achieve substantial productivity improvements. Under the consumption approach tax considerations would cease to influence the pattern of investment. Every saver and investor would have just the right incentive to seek out the highest-yielding use of resources.

Some base their advocacy of consumption taxation on the view that it would bring about an increase in the level of national saving, and hence in the national capital stock. I, myself, think this result is probable under most likely approaches to consumption-based taxes. But both theory and evidence are mixed in their predictions on this score. I would stress that, whatever the response of total capital formation, a shift to a consistent consumption base promises major gains through an improved allocation of savings--a more efficiently employed capital stock. And these gains from eliminating the existing tax distortions bearing on investment come with virtually no offsetting costs.

A further point bearing on productivity: Excluding savings from tax permits enormous simplification of the tax laws, with all this implies for improved taxpayer morale and compliance, and reduced waste of the valuable time and talent presently devoted to tax avoidance.

Won't adoption of a consumption base require a radically new set of tax institutions? Do we really need a whole new tax? Some would argue that precisely what is needed now is to scrap the existing law and substitute a new system. The Hall-Rabushka Simple Flat Tax, which is based on consumption, is an example. But one of the important facts

about the consumption approach is that it is equally compatible with gradual, phased change in the law, of the sort Congress has enacted every year or two for the past twenty years. And it is fully compatible as well with base-broadening proposals such as the much-discussed Bradley-Gephardt and Kemp-Kasten bills.

Let me then conclude by showing the practicability of the consumption approach. While many routes are available (I have mentioned the Simple Flat Tax as an example), the following six-point plan shows that we could implement the consumption strategy without radical restructuring of our tax system. The changes I mention would apply to both individual and corporation income taxes:

(1) Phase out present restrictions on deposits to and withdrawals from savings plans such as employer-provided retirement programs, Keogh plans and IRAs. Deposits to such "tax qualified" plans are deducted from the tax base, while withdrawals are included in the tax base.

(2) Phase out taxation of interest receipts, dividends, and capital gains, except as these are realized through withdrawals from tax qualified savings plans.

(3) Accelerate depreciation deductions until full first-year writeoff is the rule; similarly, move to immediate expensing of inventory purchases.

(4) Allow borrowing from a tax qualified plan, whereby the borrowed amounts are immediately subject to tax, but all repayments, of principal or interest, are fully deductible.

(5) Phase out the existing ad hoc savings and investment incentives, such as the investment tax credit.

(6) Phase out deductions for interest paid, except in the case of borrowing from a tax qualified account.

With the possible exception of the change in the interest deduction, these reforms are not particularly extreme. Tax legislation of recent years has commonly embodied shifts of similar magnitude. But this simple package of linked measures (together with repeal of vast chunks of the Internal Revenue Code now devoted to coping with the inconsistent treatment of savings) would convert the existing system to a tax related progressively to each family's power to consume.

Senator GRASSLEY. To start off, if I interpreted Mr. Cohen right, I would like to ask the other three panelists to respond to a point he made that I don't think is made here often enough, and from his experience as a former Commissioner I think we should give his point of view considerable weight, and that is that compliance is more going to be influenced by the amount of enforcement we have as opposed to where I think too many of us in the Congress come from, or at least where I come from, that it is probably more the credibility of the tax system, the concept of fairness, the understandability of it, how high the marginal tax rates are, and those things.

First of all let me ask Mr. Cohen, is that a fair analysis?

Mr. COHEN. Yes, sir, I think it is.

Senator GRASSLEY. All right. So could I ask each one of you to comment? Because I think we need that sort of reaction, because you know this whole series of hearings—let me ask my staff—comes from the other point of view.

Mr. COHEN. I should add, Senator, of course, that other attributes do have a contributing factor.

Senator GRASSLEY. But you said "marginal."

Mr. COHEN. But it is marginal. That's right.

Senator GRASSLEY. All right. And that's fair. I mean, that is what these hearings are all about, to get all of the expert testimony out on the table for all of us to consider.

Proceed.

Mr. KENDRICK. Well, I think all these characteristics you have mentioned are important. Nowadays, with computerized systems whereby tax information returns can be checked against what you report, the enforcement side isn't that difficult anymore, except in some complex cases no doubt.

Mr. COHEN. Can we debate this a little bit, Senator?

Senator GRASSLEY. Yes.

Mr. COHEN. Because I think that is another miscomprehension. A computer is a valuable essential tool that provides information. Only a human being can follow the information. We have just loads of small business people in this country. There are thousands and thousands and millions and millions of discrepancies that will show up. And the computer doesn't resolve those problems, it only raises them. That is the difficulty. We proceed on the assumption that if we had more and more computers we would need less and less people; but since we will need less and less people to keep records, we will need more and more people to analyze the records.

Senator GRASSLEY. We will find more and more discrepancies that will have to be followed up.

Mr. COHEN. But many of those discrepancies, when you follow them up, will lead nowhere. For example, my brother and I have a joint account, and it's on my E.I. number. And I will get a notice saying, "You didn't report all of the dividends from XYZ stock," and I will send them in a message saying, "I did, and I sent you another little piece of paper which evidently didn't get matched up, and it shows that my brother got half of that. That sort of thing happens. But someone must follow that up to correct the computer."

Senator GRASSLEY. Go ahead.

Mr. KENDRICK. But that pointing out of the discrepancy is an important part of getting compliance. But I agree with the implication of your question, and that is that the credibility and public perception of the fairness of the tax system is equally important in getting full payment of the tax that is due. That is one reason why I think that eliminating the double taxation of dividends and eliminating the double taxation of saving generally would help to get greater compliance, because of greater perception of fairness on the part of the public.

Senator GRASSLEY. Mr. Storrer?

Mr. STORRER. I would like to address two different aspects of that question. First, to sort of follow up on what Mr. Cohen said regarding the errors that the computer picks up, the IRS has a number of computer programs by which they check tax returns and match them with documents. They have a program called the Information Return Program, IRP. They have the Math Error Corrections Notice Program. They have the Unallowable Items Program. All of these result in notices that go out to taxpayers. And I believe with respect to the matching program of 1099's with returns, by the IRS's own admission 50 percent of the notices that go out are in error. They simply suspect there to be a mismatch, which obviously turns out not to be the case. Of the 50 percent which they indicate are correct, many of those are for innocuous sums which clients of mine simply pay without even trying to reconcile them.

So I think that matching of documents with the tax returns, when there is such an enormous number of documents, is very misleading in terms of trying to create enforcement.

Also, with respect to the enforcement aspect of things, I believe that when the public at large, regardless of whether or not they are in the 70 percent that file 1040A's or they are in the more complicated sort of the 30 percent that have schedule C's, E's, and others perceive the tax system to be inequitable. And so it leaves them, by virtue of the confiscatory rate structure, in my opinion, to cheat in ways which are indescribable. The W-4 program the IRS has is one where people just file W-4's claiming 99 exemptions and then disappear underground at the end of the year hopefully never to surface again. Family trusts sometimes used by very low income people, family trusts, and ministers certificates are a ridiculous scheme for the purpose of avoiding tax. Those are three examples of what I would describe as the poor man's tax shelter. And these are used by people who otherwise would file 1040A's, in my opinion, the 70 percent. So I think the perception of inequity is very important here, and I believe that 70 percent 1040A population perceives the system to be inequitable.

When the population perceives a law to be inequitable, it does not matter whether or not in reality it really is, because they actuate their feelings by being civilly disobedient.

Senator GRASSLEY. Mr. Bradford?

Mr. BRADFORD. Well, we are operating in an area where I think an awful lot has to go on hunch. I guess I am in the middle.

I would think that stricter enforcement would contribute substantially to compliance; however, I think that neither the enforcement nor the individual voluntary compliance is independent of either the high rates or the perceived fairness of the system. In

fact, my perception in recent years has been that Congress has declined to authorize a more rigorous program of enforcement because legislators themselves are not so confident that the tax system is fair.

There are some guidelines, it seems to me, for developing schemes that would provide for easier enforceability. I think lower rates, in my opinion, would make voluntary compliance higher; it stands to reason it would. Common sense says if the penalty is a certain amount and the amount you've got to gain from cheating drops, then you will cheat less.

The most promising way to get them for an easily enforceable system is to have one in which accounts are linked in a more systematic way than they are now, such that basically any time someone gets a deduction, and this would go especially for businesses, someone else would have an inclusion. This is the typical way in which a value-added tax is administered. And I think the general approach, again to go back to my theme, is quite compatible with a consumption-type; whereas income taxes give you a lot of trouble, basically because the rate at which an asset which is purchased is deducted by one taxpayer is not the same way it shows up in the tax return of a selling taxpayer.

Senator GRASSLEY. The answer to the next question I would like to have you submit in writing, not because of the time, which might be a factor, but just because I think that I would like to have you give it some thought instead of being under the force here. It involves the gross income tax, and "gross income" defined as "gross sales minus cost of sales"—that's an accounting term. And then "cost of sales" further defined as "direct product input." I would like first of all your views on the gross income tax; second, how such a system might affect business decisions, productivity generally; and how it might affect our compliance efforts, with all the compliance problems we have referred to, underground economy, and things like that. And then lastly, whether or not in your view the gross income tax is neutral in terms of affecting those business decisions.

Now, if there are any of you who would object to answering that in writing and would rather answer it right now, I would be glad to take the time to listen; but I would rather you would take some time to answer it in writing.

Mr. COHEN. You know, there are some States that have tried a gross income tax, Senator, and most of them have failed on the basis of the vagarities of the business world—that is, the margin of profit in one business is very large, and the margin of profit in another business is very small, and so it has a dramatic effect in the latter and miniscule in the former. That is the problem, that is, gross income is not an indication of ability to pay at all.

Senator GRASSLEY. All right.

Mr. KENDRICK. Mr. Chairman, could I just make one quick remark on a point which Mr. Bradford made, which I think is important?

Senator GRASSLEY. Yes.

Mr. KENDRICK. Although I agree generally with his viewpoint, as I understand it you either exempt saving from income or you exempt property income from taxation to avoid double taxation of

saving. And if I did not misunderstand him, he was advocating both exempting saving and the income from saving. And I think that is going too far. I mean, you do one or the other, not both. Do you get my point?

Mr. BRADFORD. I get your point, but you misread me.

Senator GRASSLEY. Then clarify it, Mr. Bradford.

Mr. BRADFORD. OK.

Senator GRASSLEY. For the record.

Mr. BRADFORD. I quite agree, there are two basic strategies for basing a tax on consumption, or more particularly for exempting the return from saving. One is to allow a deduction for saving, and then inclusion of all the return that comes back, and the other is to ignore the whole thing, neither allow a deduction at the time of saving or your tax, what the taxpayer is able to get back in the future from the act of saving now.

The scheme that I outlined in my six-point program separates two quite clearly—the deductible savings are those which are conducted through an Individual Retirement Account, or the like, and all those are deducted and all the withdrawals are included, or they are deducted through business investment. If I have a business, I deduct my outlays on capital and equipment—inventory, and so on—in which case, again, all the receipts that I get back are taxed.

Alternatively, if I simply go out and buy a bond—and don't take any deduction, don't put it in my IRA or anything of the kind, then under my scheme the return on that bond would be ignored, it would not be taxed. So there is a separation. It is very important to draw those lines carefully, and I have no doubt that by doing that carelessly we would be in trouble.

Mr. KENDRICK. Well, thank you for your clarification.

Mr. COHEN. As long as we are clarifying, Senator, could I add one more point? I think we have all talked about a variety of taxes here. The one worst system from the administrative point of view, either for the taxpayer—that is, the business taxpayer who has to keep records—or the government who has to maintain an administrative setup is to have both; that is, a VAT and the income tax, a consumption tax and the income tax, because then you are administering two systems.

We don't have anyone, for example, at the Revenue Service now who has ever administered a sales tax, a national sales tax, because we've never had one. There is a whole training exercise necessary. So if you go through the whole training exercise and then maintain both systems, you would need twice as many people.

Senator GRASSLEY. All right.

Yes, sir?

Mr. STORRER. Mr. Chairman, may I make a couple of remarks regarding progressivity? With all due respect to Mr. Cohen and his illustrious career and success at the IRS, I really believe that progressivity does create a complexity, perhaps not to the degree that it would be impossible to deal with but it does create complexity.

I will give you four examples:

One is that the filing status is necessary. Sections 2 and other sections of the Internal Revenue Code are necessary only by virtue of progressive rates. That is the reason you have them—surviving

spouse definitions are complicated, head of household definitions are complicated. Indeed a significant part of the Tax Reform Act of 1984 addressed the issue of the definition of "marriage" under section 143b, by virtue of the need to differentiate between married people and unmarried people simply because of the differing rate sections and rates that apply. The marriage tax penalty deduction which emerged out of one of the recent acts, section 221, was necessary by virtue of progressive rates that apply differently to people who are married filing a joint return with two-earner incomes in the household as opposed to single people.

Last year there was a constitutional challenge to the Internal Revenue Code brought by two governmental employees who said that it was unconstitutional to tax married people differently than single individuals.

So I mention those as indications that progressivity does create complexity.

Senator GRASSLEY. Mr. Cohen, when you write us about the gross income tax, give us a few of those States we could look at.

Mr. COHEN. Yes, sir.

Senator GRASSLEY. And their experiences. Or any sort of public——

Mr. COHEN. Mostly they have done it as licensing fees, but the net effect is the same.

Senator GRASSLEY. And if there is any written material on that, you could refer us to it.

I want to thank you all; you are a very good panel. And we appreciate the information you have given us and the expertise that you have imparted to us as well. Thank you very much.

I now call the last panel. Calvin Kent is currently director of Baylor University Center for Private Enterprise, a graduate of Baylor, advanced degrees with the University of Michigan, University of Virginia, and the University of Chicago. He studied at those latter universities as well. He has been a former staff member of this committee and also of the IRS, and he is known as a strong advocate of entrepreneurship in small business. He is also on the President's Task Force for Entrepreneurship and Small Business.

We have Jim Tatum, currently a partner in the firm of Peden, Tatum & Associates, a C.P.A. firm, and he is a graduate of Sam Houston State University, an MBA degree, and also did additional graduate work at the University of Houston in accounting. He worked with the accounting firm of Peat, Marwick & Mitchell from 1965 to 1967, and he also served as a controller and treasurer for two international oil companies between 1967 and 1975. He has been in his own private business since 1975.

Richard Vedder is currently a professor of economics at Ohio University and holds a doctorate from the University of Illinois. He has published books on the effect of the income tax on rich States versus poor States and has an economics textbook, "American Economy in Historical Perspective." He formerly has been, as well, on our committee, and Joint Economic Committee. He recently was involved with hearings there.

I would like to have Mr. Kent, then Mr. Tatum, then Mr. Vedder.

STATEMENT OF CALVIN A. KENT, PH.D., HERMAN W. LAY PROFESSOR OF PRIVATE ENTERPRISE, CENTER FOR PRIVATE ENTERPRISE, HANKAMER SCHOOL OF BUSINESS, BAYLOR UNIVERSITY, WACO, TX

Mr. KENT. I appreciate very much the opportunity of coming up from Texas and enjoying the hospitality of the committee as well as the cool climate, which is something we have not experienced down there this year.

I want to focus my remarks on the impact of recent tax changes over the last 4 years upon the entrepreneurial, small business sector of the economy, because that is the area we work with most in my operation in Baylor.

Let me begin by indicating that most of the tax changes that have taken place in the last 4 years have not, when you take them in aggregate, benefited business all that much. In addition they have, in many instances, been to the particular detriment of the smaller business, entrepreneurial sector of the economy.

I think it is important to understand that small businesses are the principal generator of jobs and the principal generator of new technologies in this Nation. Therefore, if you are concerned about the level of unemployment, about the competitiveness of America, you are very much concerned about what you can do to promote the entrepreneurial small business sector of the economy. Certainly a more favorable tax environment would be an important step in that promotion.

Sometimes we speak of business as if all business were all the same, which is not the case. There are differences between large and small businesses, and these differences mean that a tax structure which treats both large small businesses the same does not treat them the same because of these inherent differences in their characteristics.

Let me just briefly, then, mention some of those differences.

First of all, large corporations have the ability to manipulate their losses and to manipulate their tax credits. This is because they often have many divisions, often these are incorporated parts of a holding company. This means they are capable of very efficiently moving their tax credits and their tax deductions around to both promote their cashflow as well as to generate the smallest possible taxable profit for their corporation. Small businesses do not have this sort of flexibility.

In addition, small businesses are usually dependent on equity capital or upon the ability of their owner to borrow from friends and to sell participation to venture capitalists. Since small businesses are more dependent on equity and less dependent on debt, it means that the tax structure which treats debt much more favorably than it does equity discriminates against the entrepreneurial, small business sector.

With these two thoughts in mind, then let's take a look at exactly what have we done taxwise in the last 4 years which has benefited entrepreneurial small business, what have we done that has not helped it all that much, and what have we done that has hurt it.

First of all, what we have done that benefited small business has been the significant change in the Subchapter-S tax procedures, revisions in the rules for using last-in first-out [LIFO] accounting, reduction in the effective maximum capital gains tax rate, the changes in the estate and the gift taxes, and the reductions in personal income tax rates as well as the indexing of the personal income tax. All of these are major contributing factors to an improvement in the entrepreneurial, small business tax environment.

Much less beneficial, if of benefit at all in the aggregate to small business, are some of the more ballyhooed provisions of recent tax acts. Among these are the reduction in corporate tax rates. When you study this, it cannot possibly yield a benefit much more than $1,000 to most of the small businesses because the rate changes were so miniscule.

Second, the accelerated cost recovery system, the investment tax credit, and the research and development tax credits were devised so that they give their principal benefits to firms which are earning profits and can make use of the credits. Most small businesses in the early stages cannot do this as they are experiencing loses.

Detrimental changes from the small business standpoint have been the repeal of the safe harbor provisions of the ERTA Act of 1981 and the reform of the Social Security Act in 1983. Both of these were extremely detrimental to small businesses.

The steps that could be taken to improve the tax environment, if you wish to continue to work within the current code, would be to allow for tax-free rollovers of capital gains, to allow some use of unused tax credits, to establish tax-free loss reserves for small businesses, and the establishment of small business participating debentures. All of these could be done within the current code would create a much more favorable environment for entrepreneurs.

So far as flat taxes and consumption taxes are concerned, the environment for entrepreneurial small business, would be improved under these, only if there are provisions to allow expensing of investments, and the equal treatment of investment and equity capital.

Senator GRASSLEY. Mr. Tatum?

[Mr. Kent's prepared statement follows:]

INCREASING PRODUCTIVITY THROUGH SMALL BUSINESS TAX REFORM

Testimony Before
The Subcommittee on Oversight of
The Internal Revenue Service
Committee on Finance
United States Senate
September 17, 1984

Dr. Calvin A. Kent, Director
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The last four years have proved tumultuous for the federal tax system. During this time there has been the most significant changes in the tax environment for entrepreneurship and small business, since business income taxation began over seventy years ago. The great success of the Reagan Administration, during the summer of 1981, in passing the Economic Recovery Tax Act (ERTA) was significantly dimmed less than a year later when the Tax Equity and Fiscal Responsibility Act (TEFRA) was enacted. TEFRA removed almost half of the benefits granted in 1981 and over two thirds of the additional revenue under TEFRA will come from either a reduction of ERTA tax benefits, tax increases, or accelerated business tax payments.[1]

Nineteen hundred eighty two also saw the enactment of the Subchapter S Revision Act (SSRA), and the Miscellaneous Revenue Act of 1982. In addition the Social Security Program Revision Act of 1983 also directly impacted the entrepreneurial small business sector of the economy. This period of change culminated in the Deficit Reduction Act of 1984 (DRA). In addition to making extensive revisions in the Internal Revenue Code (IRC), the DRA charged the Treasury with investigating alternative tax structures which would be radical

departures from the tradition of American personal and business income taxation.

The purpose of this testimony is threefold:

1. To discuss the impact on the entrepreneurial small business sector of the economy of these tax changes by specifically delineating the extent to which these changes have increased or decreased the capacity of new and growing ventures to contribute to rising productivity in the United States.
2. To mention specific changes to the Internal Revenue Code which would substantially improve the tax environment for entrepreneurship.
3. To suggest some guidelines which should be used in evaluating the more substantive rewritings of personal and business taxation such as Gross Income Taxes and Flat Taxes.

Impact of Tax Changes on Small Business and Entrepreneurs

Viewing the last four years as a whole, recent tax changes may have left the business sector of the American economy with virtually no improvement in the tax environment. The Urban Institute did conclude that the reduction in corporate income tax rates and the accelerated cost recovery system would reduce by 85 percent corporate taxes.[2] This report did not consider the impact of the revised Social Security Payroll Taxes, the other miscellaneous fees which were raised, or the effect of other indirect business levies. At least one study has concluded that when the effect of all of these changes are taken into consideration, the result will be a slight increase in the tax burden on the business sector.[3]

The most significant impact of the recent tax changes has been the redistribution of tax burdens among firms of different size and capitalization. The entrepreneurial sector of the economy may not have faired as well as business in general. This is because most entrepreneurships are labor intensive with relatively low capitalization and insignificant, if not nonexistent, profits during the first years of their life cycle. This makes them unable to avail themselves of many of the more positive recent changes in the tax code, while leaving them victimized by others. At least two recent surveys of growth oriented small business have concluded that the effect of these tax changes has been to increase the tax burden on these firms while reducing it for other larger corporations.[4]

Those who study the life cycle of new ventures see them as first passing through a "loss generating," and then an "emerging profit" phase. During this first phase new firms experience the high costs of becoming established, their markets are poorly developed and cash flow, if not negative, will lag considerably behind expenses. During the emerging profit phase, while cash flow may be positive, the new firm is often strapped for the neccessary financing to consolidate its markets or to expand to meet increasing demand.

It is often assumed that a tax program which treats all businesses identically will meet the criterian of tax neutrality. This is not the case. Large corporations usually possess a variety of diversified and often incorporated divisions which allow them to manipulate their corporate tax liabilities. Losses in one area can be used to offset taxable profits in others. In addition, the positive cash flows

of the diversified corporation's profitable divisions may be used as venture "cash cows" for the financing of expansion elsewhere in the corporate structure. Larger firms also possess the needed expertise to keep abreast and exploit charges in the tax code.

It is fair to say that the current structure of business taxation in the United States is favorable for the established firm and less favorable to the firm in its loss generating or emerging profit phases. Recent changes in the tax law has not reversed that. Tax changes which will improve the prospects for success of entrepreneurs are those which increase cash flow during the loss generation phase and encourage additional investment during the emerging profit phase. The disproportionate contribution that the entrepreneurial small business sector makes to the generation of new jobs, particularly for first time entrants, and the creation of new technology indicates clearly that these biases should be removed if increases in productivity are to continue, employment opportunities expand, and economic growth accelerate.[5]

Tax Changes with a Positive Impact

This testimony now turns to an overview of those changes over the last four years in the personal, corporate, social security, estate and gift taxes, to determine which have reduced the bias against the entrepreneurial small business sector. The following changes can be viewed as having aided entrepreneurial small business.

Subchapter S Revision. By far the most important improvement in the entrepreneurial tax environment has been the revision of the Sub-

chapter S provisions of the Internal Revenue Code. These provisions are designed to allow smaller, closely held businesses to incorporate for legal purposes but still remain partnerships for tax purposes. Under provisions of ERTA, the number of shareholders in a Subchapter S corporation could increase to 25 and TEFRA increased this number to 35. While these changes only went a third of the way to the 100 stockholder goal established by the White House Commission on Small Business, they will increase the capacity of many small businesses to seek financing from additional equity investors.

These changes in the law also significantly reduced the administrative burdens placed upon Subchapter S corporations. Specifically, the provisions allowing passive investment income to rise from 20 to 25 percent before a firm loses its Subchapter S status and the changed treatment of capital gains and operating losses, removed unfavorable administrative provisions which shareholders have previously experienced. Under prior law, capital gains and net operating losses in excess of the stockholders basis, could not be used by shareholders on their individual returns. Under the revisions, long term capital gains, short term capital gains, long term capital losses, short term capital losses, and operating losses in excess of the shareholder's stock plus loan basis, can all be utilized by Subchapter S shareholders. This should increase the willingness of high tax bracket investors to participate in Subchapter S corporations.

Even these changes will benefit only those start up companies which are anticipating early losses since those losses can be passed through to shareholders in the form of personal tax reductions. Also

benefiting will be highly profitable companies with little need to reinvest significant amounts of retained earnings. The company seeking to retain earnings for growth may do just as well to remain a proprietorship or partnership.

Reductions in Capital Gains Taxation. Capital gains taxation has proven to be as controversial as any other portion of the tax code. Tax bills passed in both 1969 and 1976 significantly increased the rate of taxation on capital gains as well as increasing the holding period from six months to one year. Beginning in 1978, Congress lowered the effective capital gains rate from 49 to 28 percent by raising the exclusion to 60 percent of the total long term gains. The effective rate dropped to 20 percent in response to the reduction in the top marginal bracket for individuals to 50 percent under ERTA. The General Accounting Office indicated a flood of new venture capital in response to these reductions.[6] The D.R.A. of 1984 reduced the holding period for capital gains to six months from one year.

This reduction in effective capital gains tax rates and the reduction in the holding period for capital gains may not occur principally to the benefit of entrepreneurial small business sector. The Small Business Administration after surveying capital gains returns, estimated that 70 percent of the benefits of the lower effective rates will go to investors in non-equity activities such as real estate, livestock, collectables, and stock speculation.[7] As will be mentioned later, a more productive approach would be to permit the rollover of capital gains to go tax free, when these gains are reinvested in a new or existing qualified small business.

LIFO Inventory Accounting. Recent tax legislation has increased the attractiveness to new ventures of using the last in, first out (LIFO) inventory accounting measures. The employment of LIFO accounting is particularly desirable during periods of rapid inflation. When LIFO is used to replace first in, first out (FIFO) rules, inventory is valued at more nearly its current replacement cost than its historical value. Congressional testimony indicated that most small firms had not used LIFO accounting because of its complexity.[8]

Among the many positive changes enacted in the calculating of LIFO is allowing small businesses to use only one inventory pool rather than a separate inventory pool for each product line. Also important are changes allowing taxpayers to make certain adjustments to their income over a three year rather than a single year period following their change to LIFO accounting. These changes may have removed what had been considered by Feldstein to be a principle cause for the fall in investment in non-residential capital during 1950 through 1978.[9]

Since the costs of carrying inventory are a more important factor to small and new businesses than they are to established firms, these changes will be of principal benefit to new venture initiators and those expanding existing small businesses. Whether or not the simplifications have been enough to cause the entrepreneurial sector to significantly shift to the use of LIFO rules can only be determined as evidence accumulates based on the experience of existing firms.

Revisions In Estate and Gift Tax Provisions. Significant reductions in estate and gift taxes were enacted in 1976. It was felt that estate and gift taxes imposed unsupportable burdens on estates con-

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taining highly successful, closely held family businesses. The result was often the sale of the business to meet tax obligations or the necessity for the firm to bear the costs of adequate insurance to maintain the solvency of the firm. In effect, the unified credit for estate and gift taxes contained in ERTA, exempted all the estate or gift transfers aggregating $600,000 or less. In addition, the maximum unified rate was reduced from 70 to 50 percent with a four year phase-in. Virtually unlimited transfers between spouses during their lifetimes and at death were permitted.

In addition to the reduction in estate and gift tax rates, ERTA allowed taxpayers where the estate consists of a small business or farm to pay the tax in installments over a period of 14 years at only a 4 percent interest (for the first million dollars of closely held property). These alterations plus allowing redemptions of stock in closely held corporations to be treated as capital gains rather than dividend income when the decedent's stock in the corporation exceeded 35 percent of the gross estates value, have virtually eliminated any estate and gift tax disadvantages which small, closely held businesses may have faced in the past. The Small Business Administration has hailed these changes as having a substantial beneficial impact on small business. To this regard, the deferral of the reduction of the top unified estate and gift tax rate from 55 to 50 percent until 1988 contained in the 1984 Act is regrettable.

Reductions in Personal Tax Rates. Since 85 percent of all small businesses pay taxes as part of the personal income taxes levied on their owners (proprietorships, partnerships, Subchapter S corporations),

the reductions in personal income tax rates and the indexing of personal income tax brackets to eliminate the adverse impacts of inflation are bound to be beneficial to new firms. President Reagan has indicated that preserving the individual tax cuts and tax indexing enacted over the past three years is the first and foremost plank in his platform of assisting small businesses. There does not appear to be any definitive research linking the reduction in these rates with either the increase in start-ups or expansion of new ventures. But it does seem highly probable that by allowing for a higher proportion of earnings to escape untaxed that the tax environment would be improved. The question which has not been answered is whether these tax rate reductions and indexing are the most efficient way of spurring the small business economy.

Provisions of Lesser Benefit to Entrepreneurial Small Businesses

This section examines changes which have been made which were designed to increase the level of savings investment and capital formation in the economy. Basically, these were not devised as means of assisting small businesses. While many of these will incur some limited benefits to entrepreneurial small business they may actually increase the bias in favor of larger businesses which already exists in the Internal Revenue Code.

Corporate Tax Rate Reduction. Reducing the corporate tax rate was the highest priority of the White House Commission on Small Business.[10] While positive, the response of Congress and President in this area has been puny. Following ERTA, corporate tax rates did drop by 2 percentage points in each tax bracket. The maximum corporate tax rate of 46 percent still applies to income and excess of 100,000.

The S.B.A. has noted that the maximum advantage that any business will receive from these deductions is only $1,000.[11]

There is a major problem in across the board reductions in corporate tax rates. These reductions apply to all corporations and do not target their benefits to the smaller growth oriented firms. As is indicated later, there are more efficient ways than across the board corporate tax reductions to stimulate entrepreneurship.

Accelerated Cost Recovery System. Perhaps the most visible portion of the ERTA as it affected business was the establishment of the Accelerated Cost Recovery System (ACRS). The White House Commission on Small Business had advocated speeding up and simplification of depreciation schedules on the grounds that the complexity of existing schedules and rules did not allow most small firms to avail themselves of these tax advantages. In addition, these provisions gave recognition to what inflation had done to the replacement costs of existing assets.

ERTA allowed the expensing of eligible personal and certain real property over three, five, ten and fifteen year recovery periods. These provisions have been eroded by subsequent action. The DRA of 1984 has extended to eighteen years the recovery period for certain real property. The TEFRA of 1982 repealed the ACRS schedules that would go into effect in 1985 and 1986 which means that equipment will remain on a schedule which is close to the 150 percent rather than double the amount under the previous declining balance method of depreciation.

Also under ERTA, a taxpayer will be allowed to immediately expense investments of $5,000 in personal property ($7,500 in 1984-85, $10,000

Under the provisions of the ERTA, there was a significant change in the 10 percent investment tax credit granted to assets whose expected life was 7 or more years. Property with a 3 to 5 year expected life was allowed a 6 percent credit and assets with a life of more than 5 years were allowed the full 10 percent. The 1982 Act changed the ITC by providing that only 85 percent rather than 95 percent of a firm's total tax liability could be offset.

As was the case with the ACRS, small businesses will benefit to a degree from these liberalized provisions. But the entrepreneur will have to have a positive tax liability in order to obtain the benefits from the ITC. In addition, the entrepreneurship will also have to have sufficient cash flow to purchase the assets. During the loss generation phase of the new business start-up neither event is particularly likely.

Since small businesses rely more heavily than older, larger, more-established ones on used equipment, small business firms will benefit decidedly from the increase in the amount of used property eligible for the investment tax credit which is increased by steps from $100,000 to $150,000. This provision will be beneficial particularly in periods of rapid inflation.

R&D Incentives. The 1981 ERTA Act contains a 25 percent income tax credit for new expenditures on research and development (R&D). It is easy to overestimate how generous this revision is. Since the credit is non-refundable, firms without taxable income will either have to carry the benefits forward for 15 years or apply it against prior taxes paid. Most entrepreneurial small businesses will not be able to make

in 1986 and thereafter). If this immediate expensing is elected the investment tax credit for the expensed portion of the assets value could not be taken. The Small Business Administration saw small businesses, which make limited amounts of investment in equipment, this being a significant incentive. While there will be some benefit to businesses making very small capital investments, this expensing provision is not likely to be of significant impact to most growth oriented ventures because of the $10,000 limitation. Since new ventures and small businesses tend to be more labor than capital intensive and to use shorter-lived assets than do larger more established businesses, over 80% of the tax benefits from ACRS will go to the larger corporations according to Treasury estimates.[12] Entrepreneurial small businesses will benefit from the simplified bookkeeping involved, but many small businesses during their formulative period have no taxable income against which this depreciation may be applied. These depreciation changes seem to continue the bias of our tax system towards capital intensive large business and away from labor intensive smaller ones. This is not to advocate repeal of ACRS, but rather to indicate its limited usefulness to the entrepreneurial small business sector.

Investment Tax Credits. The use of investment tax credits (ITC) has been a changing feature of the United States tax policy. The objectives behind the ITC are admirable:

1. To stimulate the purchase of capital goods and thereby growth in the capital goods producing industries, and
2. To improve U.S. competitiveness by encouraging the upgrading and modernization of facilities and equipment.

use of these provisions until well into the emerging profit stage.

There are other problems with the R&D incentives. Full credit is available only for research conducted within the firm. Only 65 percent credit is allowed for research done on an outside contract basis or with university and exempt research organizations. In addition, the credit can only be claimed on expenditures which are incurred in the actual "carrying on" of the trade or business. This means that firms engaged primarily in contract research or firms just starting will find it difficult to qualify.

Many small entrepreneurial firms will have trouble using the R&D credit since it is applicable only to additional expenditures they make. Firms that are already spending a high, but constant amount on R&D, are not likely to qualify. In addition, the credit is figured on the expenditures in excess of the average over the previous three years. For new firms without three years previous experience the basis is considered to be 50 percent of the years current R&D expenditures which effectively reduces the credit to 12.5 percent.

The R&D tax credit will prove beneficial to entrepreneurships who are expanding their R&D budgets. In addition, many existing firms may be encouraged to begin an R&D program. It is reasonable to assume that the greatest beneficiaries will be the larger firms who in the past have had low R&D budgets and now expand them. Many of the newer, smaller, high-tech firms which already are spending a constant, but high proportion of their cash flow on R&D and which are not generating profits will find the R&D credit of limited value.

Detrimental Changes in the Tax Environment

Some of the recent tax changes have been clearly detrimental to the best interests of new and expanding ventures. These provisions are defective primarily because they fail to realize the need for encouraging a high and positive cash flow during the early stages of a new business' growth and development. Most of the tax credits described above are of very limited value to firms which are experiencing negative cash flow as is almost always the case during the loss generation phase of most new enterprises.

Repeal of Safe Harbor Leasing. From an entrepreneurial standpoint, one of the potentially most valuable provisions of the 1981 ERTA Act was the establishment of safe harbor leasing. As has been mentioned frequently in this testimony, a major problem of new firms during their start-up is their inability to use tax credits since they have no tax liabilities against which these credits can be applied. The safe harbor leasing provisions were viewed as at least a partial antidote to this problem.

Under safe harbor leasing, a venture with no tax liability would engage in a paper transaction transferring its tax credits to a firm with a federal tax liability. While title would actually pass to the firm needing a tax write-off, the property would then be leased back to the original firm. The firm with the original tax liability would be able to offer more favorable lease terms to the original firm because of the tax savings which the safe harbor lease arrangement would allow. Testimony before Congress indicated the majority of firms which would be unable to use the tax incentives contained in the 1981 ERTA Act

would be entrepreneurial high technology ventures.[13] For these firms it was estimated that the cost of capital would be reduced by 20 to 30 percent if they could use the tax advantages which would be otherwise made available to firms with positive tax liabilities.

Further supporting evidence for safe harbor leasing appeared when the effects of unused tax credits on business mergers was considered. New firms which had accumulated significant amounts of unused tax credits became increasingly attractive firms for mergers or buy-outs. Without safe harbor leasing it was felt that these firms would be impaled on the horns of a dilemma. Either they would have unused tax credits which would place them at a competitive disadvantage with larger profitable firms or they would be continuously threatened with the possibility of mergers or buy-outs.

Safe harbor leasing was implemented in such a way that its failure was almost assured. When ERTA was put into action firms were given no more than 90 days in which to close their leases. The firms which were able to take greatest advantage of these were the larger firms with more experienced legal and accounting staffs which could move on such short notice. Complexity of the rules established by the IRS and the IRS's regulation prohibiting closely held corporations from acting as lessors further closed the door to the use of safe harbor leasing by small firms and encouraged its abuse by larger ones. As a result, over three-fourths of the transactions and 93 per cent of the benefits of safe harbor leasings occured to larger corporations.[14]

The resulting public outrage resulted in the effective repeal of safe harbor leasing under TEFRA. Unfortunately, no new approach or

provisions have been devised to compensate for the bias against small firms with unusable tax liabilities. This failure limits the effectiveness of the tax credits discussed above as stimulants to innovation, investment, and development of new products.

Social Security Tax Reform. One of the potentially, most damaging changes which took place in the last four years is the passage of the Social Security reforms which significantly increased Social Security Taxes on the employee and employer as well as the self-employed. Early in 1983 the Small Business Task Force on Social Security established by the SBA reported that these tax increases would place a disproportionate burden on small entrepreneurial firms in the nation's economy.[14] This conclusion was based on the observation that small firms tend to be more labor intensive, employing some 60 percent of all workers covered by the Social Security system. In addition, there were over 12 million sole proprietors who pay the self-employment tax.

For those reasons the entrepreneurial sector is placed in a double bind. The additional payroll costs would reduce the ability of these firms either to compete with larger, less labor intensive corporations or would force them to pay lower and less competitive wages to their workers to absorb the Social Security tax increases. The increase in Social Security taxes may limit the future ability of small firms to continue their past level of new job generation.

Conclusions and Recommendations

The previous analysis has demonstrated that the past four years have seen only slight improvement, if any, in the tax environment for

small business and entrepreneurs. Small businesses remain at a disadvantage when compared to existing larger corporations in their ability to raise and retain the needed capital for expansion. With the exception of the changes in the LIFO accounting rules, the Subchapter S provisions, and the reductions in estate and gift taxes, few of the tax revisions have been targeted specifically with the needs of those starting and investing in new and growing ventures in mind. There are three specific legislative approaches which are consistent with that objective. All of these could be enacted within the structure of the current IRC.

Rollover of Capital Gains. Allowing investors to roll over capital gains made in qualified new ventures should be enacted. This rollover should be allowed only if the capital gains are reinvested in additional business start-ups or expansions. The precedent has already been set in the area of residential housing. Extending this principal to the entrepreneurial areas of the small business economy would lead to increases in both the amount of funds initially invested and the funds retained in new businesses.

Transfer of Unused Credits. Small businesses do not have the same flexibility as do large firms, which can more effectively use tax credits and other loss write-offs. Larger firms use credits and losses incurred in unprofitable divisions to offset profits and reduce taxes which are earned in other parts of the corporate structure. This discrepancy could be compensated for by allowing entrepreneurs to transfer unused credits which have accumulated in one qualified investment to be applied to profits earned from investments in other new

enterprises. Small firms should also be allowed to establish loss reserves which would increase the amount of retained earnings while cutting back on the amount of profits subject to taxation. A cautious approach to the finding alternatives to safe harbor leasing should be explored.

Small Business Participating Debentures. The White House Commission on Small Business urged the establishment of Small Business Participating Debentures (SBPD). The Small Business Participating Debentures take the character of both debt and equity capital. While the Small Business Participating Debentures would be essentially debt, the interest payments would be based on the firm's profits. When profits are low, the interest payments would be low but would rise as the company's profitability increased. The interest payed by the firms issuing the Small Business Participating Debentures would be treated as an expense and deducted, but the investor would be allowed to treat the interest payments received as a capital gain. The firm would achieve a tax advantage since the interest payments would be deductable as interest rather than considered as profits. Investors would receive an incentive as their income would receive the lesser rates of taxation associated with long term capital gains.

Many of the suggestions for more comprehensive reform and overhaul of the tax structure would provide general benefits to small businesses, but none would provide the specific incentives mentioned above. Since 1982, over a dozen different bills have been introduced in Congress promoting the idea of a "flat tax." While some of these bills are detailed revisions of the IRC, others do no more than call for

additional studies into the feasibility and economic effects of the general principles which they advocate. Currently, the Treasury is making an investigation of many of these proposals as is required under the provisions of the DRA.

No attempt is made in this testimony to analyze, in detail, all of the various provisions or ideas contained in these flat tax bills. These bills do vary considerably. Some call only for revision of personal income taxes while others include corporate taxation as well. The basic idea behind all of them is to expand the tax base by eliminating deductions, exemptions and credits. This expanded base would allow for a significantly lower tax rate. All the bills exempt low income taxpayers by a system of personal deductions. Some also allow for certain personal deductions such as home mortgages and charitable contributions to continue. Others are not true flat taxes since they retain tax brackets, although there would be fewer brackets than under existing law.

In considering these proposals, what should be included in the analysis is the way the entrepreneurial small business sector is treated. Do these proposals enhance the capacity of new and expanding firms to attract new capital and to retain sufficient income for purposes of expansion? Those proposals which leave the current corporate levies intact clearly are not improvements over existing conditions. While most of the bills do address personal income taxes, most do not call for extensive revisions of the way the tax on income from proprietorships, partnerships, or small business corporations are

calculated. The case for these legislative proposals must be made primarily on grounds of simplicity and not on the basis of the incentive they provide for investment in growth industries.

Those proposals which would have the greatest positive impact would eliminate the double taxation of corporate profits by having business income taxed solely to the firm at the same flat rate as individuals are taxed. Some proposals also provide that business investment may be totally expensed in the year in which the investment expenditure is made. Those proposals also would eliminate entirely any taxation of capital gains while some other proposals would retain the current favorable treatment. A few would eliminate all preferable capital gains treatment and tax gains as regular income.

Allowing for the expensing of investments would encourage additional investment and tend to reduce the current disparity between small firms which must raise most of the venture capital as equity and larger firms which can make more extensive use of debt. Since interest on debt is considered an expense and deductible, whereas dividends on equity are considered to be income and taxable when received, the current discrimination in favor of larger firms would be reduced. If the elimination of taxes on capital gains is limited to gains on the sale of business assets, then the supply of venture capital will increase and assistance will be targeted toward growth oriented business.

There is one major difficulty which has been previously discussed that these proposals do not eliminate. New firms will not find expensing of investment spending as a particularly useful tax break

unless they can convert those unused exemptions into cash to pay bills, accumulate inventory or finance expansion. As new firms accumulate these unused credits, they become increasingly attractive targets for merger. This will be particularly true as larger, more established firms, which have expensed their investments in the years they were made, may be looking for sources of unused tax credits to offset their high tax liabilities. Replacing the current depreciation system with an immediate expensing option gives large tax breaks in the first year (or years if the used portions are carried forward). Mature firms which do not maintain a high level of investment will experience high tax liabilities unless they acquire the tax credits of others. While this problem exists under the current code, it could be compounded under the proposals now being considered by Congress.

Any tax proposal which lowers the effective tax burden and simplifies compliance should produce positive economic effects throughout the economy. The entrepreneurial small business sector will be caught up in this improvement. But in the near future it may be desirable, to make those changes which target tax relief to entrepreneurs, rather than waiting until the political climate is right for the passage of comprehensive tax revisions such as the flat tax proposals. Many of these proposals contain little which would be of benefit to those firms most responsible for the generation of new jobs and the commercialization of new technology. As has been the case in the past, tax alterations designed to be of general benefit may continue to accentuate the problems of the entrepreneurial small business sector which remains the principal source of innovation and new jobs for the economy.

FOOTNOTES

[1]U.S. Small Business Administration, The State of Small Business, A Report to the President 1983 Washington, D.C. 1983, p. 339

[2]Charles R. Holten and James W. Robertson, Corporate Tax Policy and Economic Growth: An Analysis of the 1981-1982 Tax Acts, Washington, D.C., Urban Institute, 1982.

[3]Steven A. Mayer, "Tax Cuts, Reality or Illusion", Business Review, Federal Reserve Bank of Philadelphia, July 1983, pp.3-9.

[4]Kevin Farrell, "The Small Pay More" Venture, August 1984, p. 58-62 and John M. Albertine "Let's Get Rid of the Corporate Income Tax" Inc., March 1984, p. 15-16.

[5]Calvin A. Kent, "The Rediscovery of the Entrepreneur". The Environment for Entrepreneurship, Lexington Books, 1984, pp. 4-9.

[6]Quoted in Kevin Farrell, "Entrepreneurial Economics" Venture January, 1983, p. 34.

7U.S. Small Business Administration, The State of Small Business: A Report of the President, 1982, Washington, D.C., March 1982, p. 306.

[8]U.S. Congress, Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, 97th Congress, December 29, 1981, p. 149.

[9]Martin Feldstein, "Inflation Tax Rules and Investment: Some Econometric Evidence", Working Paper #577, National Bureau of Economic Research, 1981.

[10]White House Commission on Small Business, America's Small Business Economy: Agenda for Action, Washington D.C., p. 80, p. 27.

[11]The State of Small Business, 1982, p. 315.

[12]"The State of Small Business", 1982, pp. 310-11.

[13]U.S. Congress, House Committee on Oversight, Safe Harbor Leasing Provisions of the Economic Recovery Act of 1981, 97th Congress, First Session, 1981, pg. 54.

[14]U.S. Congress, Joint Committee on Taxation, An Analysis of Safe Harbor Leasing, 97th Congress, 2nd Session, 1982, p. 26.

[15]U.S. Small Business Administration, "Social Security: A Tax on Labor," Report of the Small Business Task Force on Social Security, Washington, D.C., January 1983.

STATEMENT OF JIM R. TATUM, C.P.A., PARTNER, PEDEN, TATUM & CO., HOUSTON, TX

Mr. TATUM. Thank you, Mr. Chairman.

I consider it an honor and a privilege to be here today. The testimony that I am presenting represents my own simplistic views and not necessarily those of my profession. Since I have been doing accounting and income tax reporting and financial reporting work for the 20 years of my career, you might say I have had a vested interest in what's been going on.

The Internal Revenue Code of 1954 has now been amended for 30 years. I don't think we've got it right yet. Each successive tax reform bill has served, for the most part, just to further complicate the system, and each time as it's amended it becomes more complicated and the level of compliance declines.

As earlier testimony has already pointed out, the American taxpayers perceive that the system is unfair. They are provoked, confused, and bewildered. Those who pay taxes feel that they pay too much.

I will give you an example. In a recent year I had a client who grossed $1.2 million, and he made that money the old-fashioned way—he earned it. He paid $120,000 in tax. Another client made $800,000 gross income, but he paid $300,000 in tax. Another client who was just a young fellow right out of school made $200,000 in gross income and paid no tax.

Now, the man who paid $300,000 in tax did so simply because he was a conservative investor. He wanted to use the traditional marketplaces for accumulating his capital—namely, the banking industry, the stock and bond market. He did not want to participate in all of the abusive and foolish tax shelter investments that are available in the market today.

The man who grossed $1.2 million was looking at paying $500,000 in tax under our present system. And when you look at paying $500,000 in tax for 1 year, suddenly money becomes worthless, and

any investment that offers tax-shelter opportunities suddenly makes sense.

I think this bracket creep that we've got, caused by inflation, has pushed so many working people into the 50-percent tax bracket that now we have a national epidemic of tax shelters. I think these tax shelters are encouraging people to make foolish investments. I think it is detrimental to the accumulation of capital and encourages wasteful spending and high interest rates.

Senator GRASSLEY. Let me interrupt you.

Is that epidemic of tax shelters lessening any since the marginal tax rate of 70 percent down to 50 percent?

Mr. TATUM. I don't think so. It is still epidemic proportions. I call the market a "frenzied market." It just doesn't make sense, and I hate to see my clients participate in it. But they don't seem to have much choice. And there are a lot of people who used to sell stock and used to sell insurance who are now selling tax shelters, because that's where the market is, that's where the demand is. And they are cashing in on it.

You know, my clients view me as conservative. I tend to try to encourage them not to invest in these things, because generally they are not well-managed investments, they are loaded down with sales commissions, accounting fees, legal fees, underwriting costs, management fees; the whole gimmick, the enticement for getting the money in there is the tax shelter, the tax benefit. If it weren't for the net income tax system, we wouldn't have these markets. I feel, therefore, that the net income tax system has these provisions which serve to defeat the purpose of the system—that is, raising revenue.

Well, the net income system is also very expensive to administer, as we have already talked about. Accountants like me in total spend millions of man hours each year calculating deductions, limitations, exclusions, preferences, carrybacks, carryforwards. It is ridiculous. It seems to me there could be a lot simpler way.

I would estimate that 75 percent of the cost of complying with the net income tax system could probably be eliminated if we adopted a more sensible tax code.

I think now the need for wholesale tax revision is obvious to everybody, as reflected by the fact that you have held hearings earlier in the Spring. I think the voters, or my clients which are representative of the voters, are primarily concerned about simplicity and fairness. Given the opportunity, I think every American would vote for a simple system.

Of all the methods of tax reform that have been proposed, I think that the gross income tax offers the best potential for satisfying the voters and for providing the greatest amount of revenue at the least amount of aministrative expense.

I think to understand the gross income tax system, that the definition of "gross income" is key. Gross income or gross sales would be reduced by cost-of-sales in arriving at gross profit, or taxable income. The cost of sales to me would be defined as cost of materials or services which enter directly into the product being produced by the taxable entity, provided that such materials and services are provided from an independent nonaffiliated business entity. This gross income tax—the same form, the same tax calculation—could

be made by all business entities, whether they are corporations, individuals, or partnerships.

As I see it, the gross income tax is potential profit, not artificially minimized net profit. A businessman, for example—a highly simplified example—if he is a steel manufacturer would take his gross income from the sale of his products, and reduce that by the cost of raw materials that he acquired from a nonaffiliated supplier. Therefore, the difference, if he sold steel at—and I am just picking a number—$100 a ton and his raw materials cost him $30 a ton, his potential profit would be $70. He would pay a low rate gross income tax on that potential profit. How he managed his business, how he produced that steel is then his decision. And I think he would then have incentive to manage his business, to produce his profit in the most efficient manner, and then to retain the capital that resulted from his operations and invest it in the most judicious manner.

The C.P.A. profession right now employs most of its manpower to reduce Federal income taxes. We serve our clients. They feel they are paying too much in taxes, and they hire us to represent them. I think that if the gross income tax were enacted, it is as simple as it could be to me that a business could file its tax return every month. Then the C.P.A. profession could be used in a way more supportive of the income tax system. For example, if the tax returns are as simple as they could be, the C.P.A.'s could, by requirement of law, review and sign these gross income tax returns.

A gross income tax system obviously would have to be phased in over a period of time. My first thought on that idea would be, say, to have a 5-year phasein period, where each business could prepare either the net income tax return or a gross income tax return, and he could pay a weighted average of the two taxes, with the higher weight going to the net income tax calculation in the earlier years, shifting gradually to a higher weight going to the gross income tax in later years. You know, this dual tax computation is what we have now, with the regular income tax, the alternative income tax, the income averaging, the 10-year averaging. I have prepared tax returns that have had probably as many as four different tax calculations.

To me, the great challenge facing Congress today is to balance the budget without creating a tax revolt, because I can promise you the taxpayers are fed up with it. The ones that I work with, some of them have just declared war on the IRS. They are going to do everything they can to keep from paying taxes—including making foolish investments.

I think the gross income tax provides you the golden opportunity to solve the dilemma facing this country today. In other words, you can go to the voters, and you can give them a simpler tax law. You can broaden the tax base. You can increase compliance. You can raise revenue. And you can balance the budget.

It seems to me that income taxes really represent the cost of government. I know it is just part of the cost of government, because you have other taxes; but I think the gross income tax could probably combine income taxes, Social Security taxes, estate and gift taxes into one simple tax, and the cost of government—I don't un-

derstand why it can't be paid by every businessman every month, just like paying the rent, based on his gross profit.

I know you have special interests that you have to deal with, and everybody wants their special deal, and I know different businesses have different profit margins, and all this makes it very complex. But I think most of the objections that have been raised reflect special-interest thinking. And I think Congress, if it is going to solve the problem, has to look beyond a multitude of special interests and try to represent the interest of the country as a whole.

I think the net income tax system we have now represents or reflects the work of politicians who have catered to special interests, but the solution we need today requires the work of statesmen.

Thank you.

Senator GRASSLEY. Mr. Vedder?

[Mr. Tatum's prepared testimony follows:]

STATEMENT

TO

SENATE FINANCE SUBCOMMITTEE

ON

OVERSIGHT OF THE INTERNAL REVENUE SERVICE

SEPTEMBER 17, 1984

HON. CHARLES E. GRASSLEY, CHAIRMAN

PEDEN, TATUM & CO.

CERTIFIED PUBLIC ACCOUNTANTS

JIM R. TATUM, PARTNER

2801 POST OAK BLVD., SUITE 270

HOUSTON, TEXAS 77056

My name is Jim Tatum. I am a CPA from Houston, Texas where I have been doing accounting and income tax work for twenty (20) years. For the last eight (8) years, I have been a partner in a small firm known as Peden, Tatum & Co. Virtually all of my time and energy is dedicated to serving clients.

Our clients consist of individuals and their privately held companies engaged in businesses such as: Architure, Engineering, Legal, Medical, Retail Sales, Equipment Rental, Wholesale Distribution, Metal Fabricating, Real Estate Development, Commercial and Residential Construction, and various investments. In my opinion, our clients represent a cross-section of basic federal taxpayers. I am grateful for the opportunity to be here today. I hope that my testimony will provide some insight into the problems with our federal tax system at the grass-roots level.

I have had a vested interest in tax reform since the beginning of my professional career. The CPA profession, outside of its role of auditing publicly held corporations, owes its existence to our federal net income tax (NIT) system. According to the September, 1984, issue of Money Magazine, sixty thousand (60,000) college students were graduated this year with accounting degrees. The Bureau of Labor statistics has predicted that job demand for accountants will grow by as much as 40% in the next decade. It appears that I and many other accountants would be more securely employed in future years if Congress continues its trend of annual

tax legislation. But, the purpose of my testimony is neither to advocate for my own personal benefit nor to represent the special interests of my profession. Tax reform needed today must come from unselfish interests in order to achieve a system that benefits us all with fairness, simplicity, and effeciency.

Each successive tax reform bill has served, for the most part, to further complicate the Internal Revenue Code. With each increase in complexity, the level of compliance has declined. Our NIT system has become a kaleidoscope of everchanging laws, regulations and rulings that are beyond human comprehension. Millions of manhours are spent each year calculating deductions, limitation, exclusions, carrybacks, carryovers and preferences. Millions of manhours are also spent each year in courtrooms debating the correctness of such calculations.

American taxpayers are prevoked to the point of hostility by this excessive complexity. Given the opportunity, every taxpayer would vote for a more simple system.

Tax payers also resent the amount of taxes thay are required to pay because they perceive that the system is unfair. There is widespread belief that wealthy individuals and large corporations have the opportunity to pay little or no tax. Those who pay taxes often feel that they are paying more than their share. Public hostility and resentment caused by complexity and inequity of our

tax system has created an adversarial relationship between taxpayers and the IRS. Due to bracket creep caused by inflation, taxpayers are becoming more aggressive in their efforts to reduce taxes. The IRS, having the unpleasant task of enforcing compliance and collecting taxes, is becoming offensively agressive in carrying out its responsibility. Please see exhibit "A" for an actual taxpayer letter regarding experience with the IRS. Unfortunately, the task of the IRS is so unpleasant and the tax system is so complex that the IRS is unable to keep an adequate number of qualified agents in the field. The level of compliance with our NIT system will continue to drop in coming years.

Recent tax reform has been enacted for the purpose of closing loopholes, limiting preferences, discouraging abusive shelter, and encouraging compliance. However, the NIT system still provides tremendous opportunity and encouragement for taxpayers to reduce their taxable income. The desire by taxpayers to reduce their taxes is growing more intense each year. Many investment syndicators, security brokers and financial planners are cashing in on this multi-million dollar market. They are convincing millions of Americans that tax dollars can be converted into wealth simply by making certain investments. Tax shelter vendors are selling the idea that taxes may be totally avoided with the purchase of their products. CPA's are also becoming more agressive by encouraging and, in some cases, even selling tax shelters.

This frenzied market for tax shelter places millions of dollars into wasteful, mismanaged, and often fraudulent, investments each year. The NIT system also encourages businesses to incur non-essential tax deductible expenses. Unfortunately, expenditures for tax shelter and tax deductions redistribute wealth primarily among the wealthy. Not enough of such expenditures provide capital for investments more economically beneficial to our national economy. Capital shortages, together with resulting high interest rates, have persisted since the early 1970's. Such conditions can be directly attributed to our NIT system.

The costs of our NIT system in terms of its effect on our national economy is probably immeasurable. The obvious cost to government and taxpayers for administration, legal fees, accounting fees and record keeping is an overwhelming burden in itself. But, the hidden economic cost, high interest rates, manhours wasted by professionals, and the lack of jobs for unskilled workers is bound to be much greater.

I estimate that 75% of the obvious costs of our NIT system could be eliminated with the adoption of a sensible tax code. Unless proper action is taken by Congress to reverse our historical trend in federal taxation, the NIT system will eventually collapse under its own weight of complexity and inefficiency as it fails to provide the revenue required for federal government.

I view our NIT system as a "tar baby". The more Congress hits it with reform, the more bogged up and ineffective it becomes. The Internal Revenue Code of 1984 has been amended for thirty (30) years. I think it is time to throw the whole mess into the "briar patch" and start all over.

The need for a wholesale revision of our federal tax system is now obvious to most voters as well as members of Congress. It is my understanding that the following reform proposals have been considered:

THE GROSS INCOME TAX

THE FLAT RATE TAX

THE VALUE ADDED TAX

THE NATIONAL SALES TAX

THE DEDICATED EXCISE TAX

THE UNIFORM CONSUMPTION TAX

Voters are primarily concerned about simplicity and fairness. Members of Congress, I suspect, are primarily concerned about increasing revenue in the most politically expedient manner.

In my opinion as a professional accountant, the Gross Income Tax (GIT) is clearly the best choice of the various alternatives listed above. I think the GIT system has the potential for satisfying a landslide majority of voters with simplicity and fairness. The GIT system also has the potential for providing the greatest amount of revenue with the least amount of administrative

expense. Maximum levels of compliance could also be achieved with GIT. Everybody wins with GIT because of the overall national economic benefits which can be achieved by changing from NIT to GIT.

Detailed descriptions and definitions of the GIT system are covered in publications available from:

Government Research and Development Foundation
309 Main Street
Blanco, Texas 78606

The simplicity of GIT is best illustrated by exihibit "B" which is a sample one page Gross Income Tax Return. A return such as this could be easily prepared and filed by business entities and individuals liable for the tax. The returns are simple enough to be filed monthly, thereby providing a steady cash flow to the U.S. Treasury Department.

Gross income taxable (at a low rate) under the GIT system would be defined by accountants as gross profit, using the direct costing method for calculating cost of sales. In other words, gross sales (exlcuding discounts and bad debts) of a taxable entity would be reduced by the costs of direct materials and services acquired from separate parties to arrive at taxable income. Gross sales of a steel manufacturer, for example, would be reduced by the costs of raw materials that go directly into and become a part of the product, provided that such materials are acquired from an

independent non-affiliated entity. Gross sales of a lumber mill would be reduced for the costs of timber processed by the mill in the production of lumber products.

The definition of cost of sales is very critical to the simplicity of the GIT system. In order for GIT to be simple, I think the term cost of sales should mean "direct cost" incurred for goods or services provided by a "separate party" entity. Direct Cost refers to the cost of actual materials or services that enter directly into and become a part of a product or service that is sold by a taxable entity. A Separate Party is an independent entity that is non-affiliated by common ownership. The term "separate party" exlcudes employees, subsidiaries and brother-sister companies.

The adoption of a GIT system will, no doubt, require a phase-in period because of the long-term business decisions made under our present NIT system. I suggest that during the phase-in period, taxpayers could calculate both NIT and GIT. The tax due could be a weighted average of the two amounts giving more weight to NIT in the earlier years and gradually transferring weight to GIT in later years. After GIT is fully phased-in, GIT returns could be filed monthly.

The CPA profession, which now employees its manpower to reduce federal taxes, could be used in a way more supportive of the tax

system. Under the GIT system, tax reporting could be simplified to the extent that each GIT return, by requirement of law, could be reviewed and signed by an independent CPA or other qualified individuals. The IRS could audit selected returns and work in conjunction with the AICPA to develop professional procedures and standards for reviewing taxpayer records supporting a GIT return. In this manner, the CPA profession could help ensure virtually 100% compliance. Furthermore, the IRS would not serve as a direct adversary of the taxpayer.

The great challenge to Congress today is to balance the Federal Budget without creating a tax revolt and economic chaos. To find the solution to meet this challenge, Congressional leadership must have the courage to look beyond the multitude of special interests. I think the proposed GIT system offers an unbiased framework based upon independent research in which Congress should concentrate its attention. The NIT system we have today reflects the work of politicians. The solution we need today requires the work of Statesmen.

EXHIBIT 'A'

Don McKuin Electric Company, Inc.
7400 ASHCROFT - HOUSTON, TEXAS 77036 - (713) 772-3637

June 21, 1983

The Honorable Ron Paul
1234 Longworth
House Office Building
Washington, D. C. 20515

Dear Mr. Paul:

We are sorry we were unable to attend your get acquainted meeting at your new offices at 4545 Bissonnet in Bellaire, Texas. As my secretary explained, we were out of town at that time.

There is something we feel needs to be called to the attention of our law makers and representatives in Congress. We have always taken great pride in everything about America. We are proud of our heritage. We are proud of the freedom we have been able to enjoy. However, we have experienced a form of harrassment lately that has caused us to wonder just how much freedom we really have as a citizen of the United States, paying taxes to the Internal Revenue Service.

This letter will be a rather lenghty letter but I do hope you will take time to read it in its entirety as we do not feel you can get the true picture without knowing every little detail.

Our Electrical Contracting firm has been in business since June 1, 1967. We started our business with approximately $350.00 operating money in the bank and built it to its present size, based on honesty and good will. We believe an honest days work deserves an honest days pay and vice versa. Most of our advertising is by word of mouth and we feel this is the best means of advertising.

In February, 1979, our records were selected by the Internal Revenue Service to be audited for the years 1976 and 1977. The examiner was Ron Scott, who was a capable examiner and we cooperated in every way, furnishing him with all data and records he needed for the audit. There was an adjustment made in the amount of $285.00 for the corporation and $190.00 personal adjustment. This was mostly due to the fact that we have a company car which we use partially for personal use and partially for company use. In discussing how much we used the car for company use, it was determined that at least 50% was used in the company and 50% for business. We therefore agreed to pay 50% of the fair market rental value to the company for personal use, the amount to be turned in on our W-2 form at the end of each year as compensation.

Again, in November, 1979, the same year, our records were again selected for audit by the Internal Revenue Service for the year 1978. The examiner's name was Richard Pisarri, and he too was a very capable examiner and we again tried to cooperate in every way we could to supply any needed information. That year we received a refund for overpayment in the amount of $98.01.

The following year, 1980, we were again selected for audit of our 1979 records. At this time we felt that this was harrassment. We called and complained to someone at the IRS Office and that person stated they did not realize we had been audited that many times and canceled the audit. We explained we were a relatively small office with a small office staff and an audit took up a great deal of time from our work to obtain records and data for the examiner. This person was extremely nice and understanding.

Now, again this year we were notified on March 28, 1983, that we had been selected for an audit of our 1980-1981 records. Even though we still felt this was harrassment, we agreed to talk to the examiner and explain how we felt and then if he wanted to proceed with the audit, we would cooperate with him. We asked why our records kept coming up for audit and he said, his supervisor just felt this was a "good case". In trying to find out what consisted of a "good case", he said he did not know why we were selected.

This time the examiner's name was Alan Pena. He came to our office on April 8, 1983. We were willing to cooperate with him also in furnishing him needed information. However, from the word go, cooperation with Mr. Pena was almost impossible, as he came into the office with an intimidating attitude, using the power of the IRS to try to put a scare into us. He did not present his identity card to us at this time.

He first started checking our receipts, trying to match invoices paid with deposits made. We noticed he was having trouble, so we asked if we could be of assistance. We saw he was trying to match an invoice typed in October with the October deposit slips. There was a November date stamped paid on the invoice, so we told him to match the invoices with the deposit slip that had the same date as the one stamped paid on the invoice. He then had no trouble. It would be great if we could receive the money the same date we type the invoice but unfortunately that is not the way things work.

He must have been agitated because we found it difficult at times to understand what he was asking. He asked us for a "toe-a". We asked him several times to repeat it and finally our secretary said she believed he was asking for a "tour". At another time he wanted to know if we did any "battering". After some deliberation and explanation of what the term meant, we determined he meant "bartering". This must have been frustrating and a little humiliating to him, but it was not intentional on our part. Later we learned he was from the north (he said Massachusetts) and had only been with the IRS for 10 months.

We are members of the Independent Electrical Contractors of America. Mr. McKuin was President of our local Houston Chapter that year and Mrs. McKuin was President of the Ladies Auxiliary of the Independent Electrical Contractors of America. In order to fulfill our obligations as officers, we needed to attend some State Meetings, Executive Meetings, Legislative Workshops, and our National Convention which is held once a year. When Mr. Pena checked these expenses, he said how did he know whether we were in attendance or not. He wanted a brochure showing a list of the activities, even though he had our registration fee receipt, our hotel bill and airline receipt showing we attended. However, trying to cooperate, we found a brochure in our files and gave it to him. He immediately put the brochure down in front of Mrs. McKuin and wanted to know which of the activities she attended. She pointed out a list of them, such as opening ceremonies, open house, Ladies Auxiliary Meeting, Exhibits in which

she had to work in a booth, etc. He then started pointing at each activity saying "Did you attend this one? This one? This one?", etc. She pointed out that she had never been asked questions such as this before and in this manner. He stated he was trying to separate business from pleasure. She replied that she had attended every activity on the brochure that was required of her as a member of the Ladies Auxiliary. He, in turn, disallowed all her expenses for every meeting and recommended charging them back to us.

He inquired about the rental of the building out of which we are operating. We informed him that we owned the building personally and rented it to the corporation, and remarked that surely that would not be questioned since we only charge $400.00 a month rental fee. He stated he certainly would question it, he certainly would.

He wanted substantiation for use of the 1979 Oldsmobile for business. We explained that we paid half the rental value for use of the 1979 Oldsmobile as instructed by a previous IRS Agent since half was used in business and half in personal use. He stated that what another IRS agent said we could do and what he was going to do were two different things and one had no bearing on the other. We would like to point out that we pay professional people to represent us, keep our records, file our income tax, etc., in order to make sure we comply with government regulations, which includes the IRS. If each time an examiner for the IRS does his own interpretations of what these rules and regulations require, then we would be changing our record keeping each time a new examiner comes out to audit. This can become quite expensive and time consuming.

After going over the records for the 1980-1981 year, he told me he had found several adjustments to be made and he was recommending them to be charged as dividends. He also said he was going to a real estate office and find out the fair market value for rental of this building and if we were not renting it for enough, he was recommending it be charged back as a dividend. We tried to explain to him he could not do that as you have to have a monetary value to charge a dividend. He said he could do it. We again tried to explain that if we were renting the building for $1,200.00 a month and it was only worth $800.00, we could understand how a dividend could be charged for the extra $400.00. But since we only charge $400.00 a month when we probably could get $800.00 to $1,000.00 from someone else, how could he charge back a dividend? He said he could do it. He did not know exactly how but he would go and read up on it and when he came back he would explain to us how he could do it. The next morning Mr. Pena called back and said he was dropping the question of the rent of the office building, and after a long pause he said, "I was wrong."

He stated he wanted to go ahead and audit our 1981-1982 records as he had found enough adjustment to warrant going into the next year. We told him that we would talk this over with our CPA and get his advice and let him know.

After talking with our CPA, we were of the opinion that Mr. Pena was a very inexperienced examiner and that our company was being used as a training ground for him. It was costing us considerable time and money and we felt this was very unfair. Our CPA agreed to meet with Mr. Pena the next time he came to our office and talkedto him. We wanted to tape this conversation, because we had decided to refuse to let Mr. Pena audit the next year because of his inexperience

but were willing to let another experienced agent do so, and we did not want the IRS to feel we were refusing to have our books audited. If this were on tape then it could not be misinterpreted by anyone. However, Mr. Pena refused to let us tape this as he said we were to let him know ahead of time so he could bring his own tape recorder.

Our CPA asked Mr. Pena for his identity card, which is the first time he presented it. After questioning him, we learned that he was from Massachusetts and had only been with the IRS for 10 months, as previously stated. He told our CPA that he felt he had found enough adjustments to warrant going into the next year, but both parties agreed that we would not do so until we had time to talk to his superior. Our CPA called and talked to a Paulette Reese, Acting Manager of the office, and later we, ourselves, called her to explain to her that we felt Mr. Pena was too inexperienced to do this audit, that he had harrassed us and used an intimidating type attitude to try to scare us. The only thing she said was "I am sorry, Mrs. McKuin." She also discouraged us from changing to another agent as she said this would only prolong the audit. We told Ms. Reese that we were going to tape record Mr. Pena the next time he came out and she laughed and said something to the effect that we were not one of the tax evaders, were we. We told her we were willing to pay our fair share of taxes but we felt we were being harrassed by the IRS and would like a tape of what was going on. We explained we felt we were being threatened. Feeling that an experienced Manager would probably be more reasonable and listen to explanations, since Ms. Reese was just filling in, we agreed to let Mr. Pena do the 1981-1982 audit. Mr. Pena was advised to bring his tape recorder as we wanted a tape of each thing he said, in view of the threats he had made regarding dividends.

Mr. Pena showed up at our office on April 26, 1983, to complete the next year's audit (1981-1982) He was upset because we insisted that the tape recorder be on. He only came into my office three times during the day to ask questions and get data. At least the tape recorder served to keep him from threating or harrassing us.

Mr. Pena wrote a total of 15 pages of adjustments. We had to contact our CPA again and go over each one of these to try to answer and substantiate them. This took one whole day. Mr. Pena met with our CPA one whole day to go over the substantiations. Mr. Pena still refused to accept our substantiations or explanations. Some of the adjustments had receipts and explanations attached which he had overlooked and he suggested that they were not there when he checked them first. But the original staple was there that held them together. We purposely did not remove the staple to make a copy because we did not want to be accused of doing this.

He would not accept the list of uses for the 1979 Oldsmobile nor the mileage kept for one full week for the El Camino showing the total mileage of 335 miles for 5½ days, out of which 5½ miles were used to and from work. We feel it is necessary to drive the El Camino home for storage and to protect the company's property. Our construction trucks are all stored and locked in our warehouse as they are loaded with equipment and there is no room for the El Camino. If we left this truck outside the office, it would be burglarized.

Our CPA met with the Branch Chief at Mr. Pena's office, a Mr. James Heinrich and went over all the adjustments with him. He stated Mr. Pena was doing exactly what he was instructed to do. This was another expense to us for our CPA's time. We informed our CPA that regardless of who they sent out here

to examine our records that we would regard it as harrassment. He did state that he had cautioned Mr. Pena on his telling customers that he was declaring dividends.

We would also like to point out that we try to impress upon our employees that they help create an image of our company by their manners and appearance. Mr. Pena's mannerisms, his personal habits and his personal grooming were very offensive to us and especially to his profession. Sometimes it was nauseous to be in the same room with him while he was writing. We were embarrassed to have our employees and especially our customers see him and think maybe he was an employee of Don McKuin Electric Company, Inc. We are especially embarrassed that he represented any part of our government. Most of all, our taxes were helping pay his salary.

As stated before, we have always been proud of our country, our government, and have always felt it a duty and obligation to pay our share of taxes for the benefits and protection we receive. However, after going through this ordeal with Mr. Pena, this is one benefit and protection that we can well do without.

Several individuals have told us that you can't fight the IRS. They say you might as well go along with them and pay whatever they say. Also, we have been told if we disagree and fight them on anything, that our records will be flagged and they will harrass us each year. This is hard for me to believe. Is the IRS a big monster that stands over us with a big stick, telling us to do this or else? We feel that the IRS is unreasonable in our case, and we feel as citizens and taxpayers that we do have some rights. Are we wrong?

Thank you for taking the time to read this.

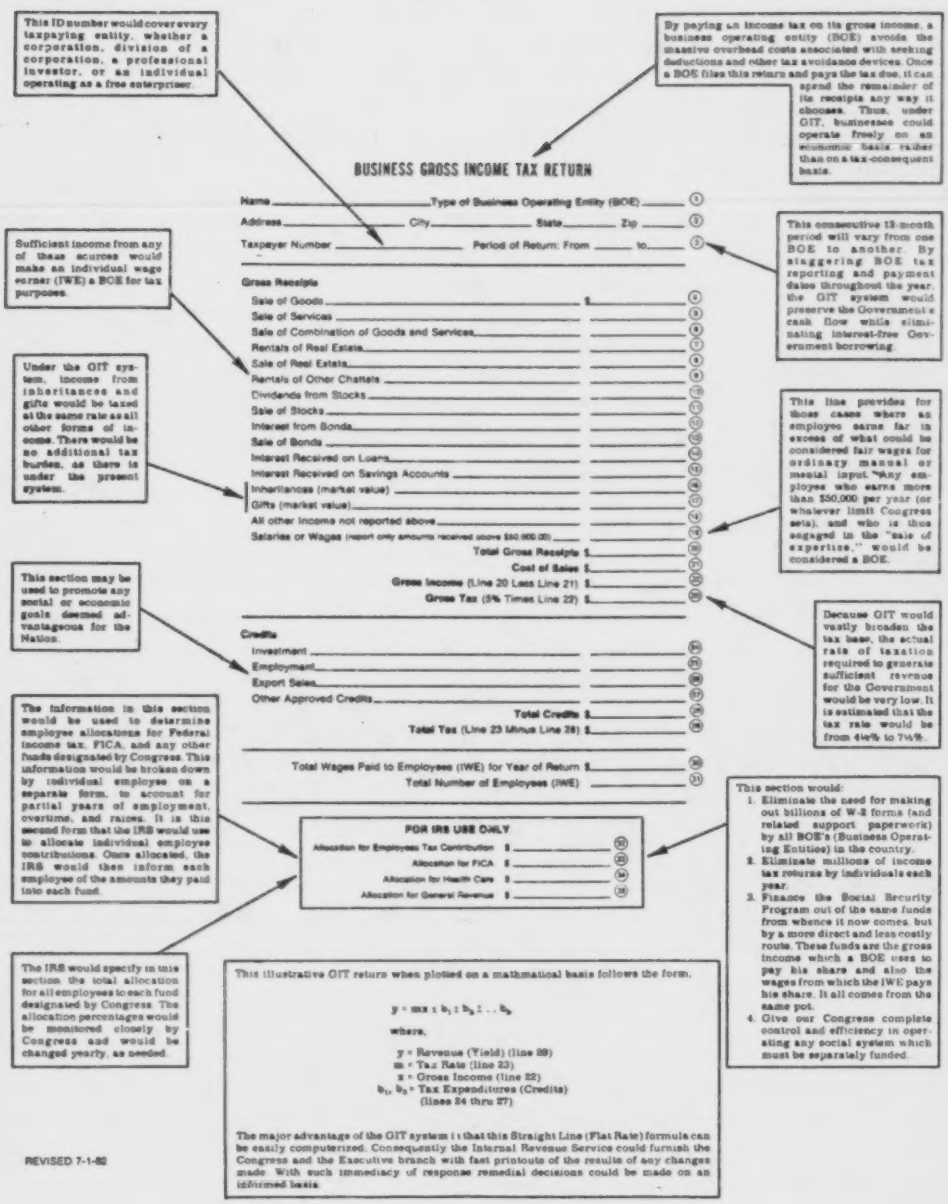
Your constituents,

Donald G. McKuin
DON McKUIN ELECTRIC COMPANY INC.

Wilma L. McKuin
DON McKUIN ELECTRIC COMPANY, INC.

/wm

EXHIBIT 'B'


This ID number would cover every taxpaying entity, whether a corporation, division of a corporation, a professional investor, or an individual operating as a free enterprisor.
By paying an income tax on its gross income, a business operating entity (BOE) avoids the massive overhead costs associated with seeking deductions and other tax avoidance devices. Once a BOE files this return and pays the tax due, it can spend the remainder of its receipts any way it chooses. Thus, under GIT, businesses could operate freely on an economic basis rather than on a tax-consequent basis.
BUSINESS GROSS INCOME TAX RETURN
Name _____ Type of Business Operating Entity (BOE) _____ (1)
Address _____ City _____ State _____ Zip _____ (2)
Taxpayer Number _____ Period of Return: From _____ to _____ (3)
This consecutive 12-month period will vary from one BOE to another. By staggering BOE tax reporting and payment dates throughout the year, the GIT system would preserve the Government's cash flow while eliminating interest-free Government borrowing.
Sufficient income from any of these sources would make an individual wage earner (IWE) a BOE for tax purposes.
Gross Receipts
Sale of Goods _____ $ _____ (4)
Sale of Services _____ (5)
Sale of Combination of Goods and Services _____ (6)
Rentals of Real Estate _____ (7)
Sale of Real Estate _____ (8)
Rentals of Other Chattels _____ (9)
Dividends from Stocks _____ (10)
Sale of Stocks _____ (11)
Interest from Bonds _____ (12)
Sale of Bonds _____ (13)
Interest Received on Loans _____ (14)
Interest Received on Savings Accounts _____ (15)
Under the GIT system, income from inheritances and gifts would be taxed at the same rate as all other forms of income. There would be no additional tax burden, as there is under the present system.
Inheritances (market value) _____ (16)
Gifts (market value) _____ (17)
All other income not reported above _____ (18)
This line provides for those cases where an employee earns far in excess of what could be considered fair wages for ordinary manual or mental input. Any employee who earns more than $50,000 per year (or whatever limit Congress sets), and who is thus engaged in the "sale of expertise," would be considered a BOE.
Salaries or Wages (report only amounts received above $50,000.00) _____ (19)
Total Gross Receipts $ _____ (20)
Cost of Sales $ _____ (21)
Gross Income (Line 20 Less Line 21) $ _____ (22)
Gross Tax (8% Times Line 22) $ _____ (23)
This section may be used to promote any social or economic goals deemed advantageous for the Nation.
Because GIT would vastly broaden the tax base, the actual rate of taxation required to generate sufficient revenue for the Government would be very low. It is estimated that the tax rate would be from 4¼% to 7½%.
Credits
Investment _____ (24)
Employment _____ (25)
Export Sales _____ (26)
Other Approved Credits _____ (27)
Total Credits $ _____ (28)
Total Tax (Line 23 Minus Line 28) $ _____ (29)
Total Wages Paid to Employees (IWE) for Year of Return $ _____ (30)
Total Number of Employees (IWE) _____ (31)
The information in this section would be used to determine employee allocations for Federal income tax, FICA, and any other funds designated by Congress. This information would be broken down by individual employee on a separate form, to account for partial years of employment, overtime, and raises. It is this second form that the IRS would use to allocate individual employee contributions. Once allocated, the IRS would then inform each employee of the amounts they paid into each fund.
This section would:
1. Eliminate the need for making out billions of W-2 forms (and related support paperwork) by all BOE's (Business Operating Entities) in the country.
2. Eliminate millions of income tax returns by individuals each year.
3. Finance the Social Security Program out of the same funds from whence it now comes, but by a more direct and less costly route. These funds are the gross income which a BOE uses to pay his share and also the wages from which the IWE pays his share. It all comes from the same pot.
4. Give our Congress complete control and efficiency in operating any social system which must be separately funded.
FOR IRS USE ONLY
Allocation for Employees Tax Contribution $ _____ (32)
Allocation for FICA $ _____ (33)
Allocation for Health Care $ _____ (34)
Allocation for General Revenue $ _____ (35)
The IRS would specify in this section the total allocation for all employees to each fund designated by Congress. The allocation percentages would be monitored closely by Congress and would be changed yearly, as needed.
This illustrative GIT return when plotted on a mathematical basis follows the form.
$y = mx \pm b_1 \pm b_2 \ldots b_n$
where,
y = Revenue (Yield) (line 29)
m = Tax Rate (line 23)
x = Gross Income (line 22)
b_1, b_2 = Tax Expenditures (Credits) (lines 24 thru 27)
The major advantage of the GIT system is that this Straight Line (Flat Rate) formula can be easily computerized. Consequently the Internal Revenue Service could furnish the Congress and the Executive branch with fast printouts of the results of any changes made. With such immediacy of response remedial decisions could be made on an informed basis.
REVISED 7-1-82

STATEMENT OF RICHARD K. VEDDER, PH.D., ECONOMICS DEPARTMENT, OHIO UNIVERSITY, ATHENS, OH

Mr. VEDDER. Thank you, Senator Grassley.

There are two disadvantages of going last, one of which is nearly all of the audience has left, and the second is that nearly all the other witnesses have said what I wanted to say, particularly Professor Kendrick and Professor Bradford. But nonetheless, I will proceed under that handicap.

Let me make five points based on my own research into tax issues, not only at the Federal but also as it relates to the State and local level.

The first point, of course, is one that numerous other witnesses have made, that the current tax system fails miserably on all of the criteria that are usually applied to evaluate taxes. I won't say any more about that. Others have done a good job.

My second point is that the evidence from the States' experience, the State fiscal experience, suggests, other things equal, that the higher the overall level of taxation the lower the rate of economic growth. The growth-inducing effects of governmental expenditures financed by higher taxes are apparently more than offset by the growth-inhibiting disincentives associated with these higher taxes. Whether the evidence of the States is entirely transferable to the Federal experience I think is somewhat debatable, but it is hard to believe that the State and local experience is totally irrelevant.

The third point I would make is that my research, which covers the period of the current Internal Revenue Code, 1954 up through 1982, using statistical techniques such as multiple regression analysis, shows that the higher the maximum marginal Federal income tax rates are, the fewer returns that are filed from high-income Americans, and also the less income is received from these groups. This, incidentally, refers to the little discussion we were having earlier with Commissioner Cohen and others. I am firmly of the view that lower marginal tax rates do increase significantly compliance, and I think there is statistical evidence to back that point up.

At least to a limited extent there is evidence in the higher marginal rate brackets that we are in the negative portion of that infamous Laffer Curve, and that by attempting to tax the golden goose too much it has sort of run away.

The fourth point I would make, returning again to the evidence of the States, is that, other things equal, the higher the reliance on income taxes as opposed to consumption taxes, the lower the rate of economic growth. If two States both take the same percentage of personal income from individuals in taxes but one relies mainly on sales taxes and the second relies mainly on income taxes, the State that relies more on sales taxes, other things equal, has tended in the last 15 years anyway to have a higher rate of economic growth.

Therefore, I would conclude from this that that evidence would suggest that income taxes are more growth retarding and have more growth retarding disincentive effects than sales taxes.

Fifth, other things equal, States with high progressive marginal rate structures in their income tax tend to have slower rates of economic growth than States with relatively flat rate structures.

Now, what are the policy implications of all of this? Three, in particular. First, any so-called tax reform that merely piles a new tax on top of the old inefficient system will likely have adverse effects even if the new taxes are in themselves less growth-impeding than the existing ones. Using the need for tax reform to foist new taxes on the populace without radically overhauling the existing system would be economically unfortunate, and I think I would agree with Commissioner Cohen on the point there that it would also add to the administrative complexity of the system.

Second, critically important in any form is a sharp reduction in marginal tax rates, and probably some reduction in the spread between the lowest and the highest rates. Practically any move in the indicated direction would require substantial widening of the tax base.

Third, the statistical evidence at the State and local level supports reducing reliance on income taxation as currently defined and increasing reliance on consumption oriented taxes, for reasons that were mentioned earlier by Professor Kendrick and Professor Bradford, to the extent of course that we view an increase in the rate of economic growth as a desirable macroeconomic objective.

Since Mr. Tatum has mentioned the gross income tax proposal, and since you, Senator, apparently have some interest in this concept, I might make a couple of remarks briefly about that. And I am thinking in particular of the proposal of Mr. Jones of your staff.

I think the proposal is intriguing, because it does have a great potential of broadening the base and reducing the rates. There seems to be some problem in my mind right now as to the nebulous definition of the term "cost of sales" in Mr. Jones' proposal. Under Mr. Tatum's interpretation, which I would hope would be a correct interpretation, the tax could be viewed as somewhat close, in my mind, to a value-added tax, since you are merely subtracting the cost of materials and are in fact taxing the value added at the firm level.

Now, I happen to think value-added taxes are desirable taxes, and I like the term gross income tax rather than the term value-added tax. If anyone remembers what happened to Mr. Ulman after he advocated a value-added tax, there may be some advantages to this approach; but I do think that it comes close to being that.

I think one has to be very careful in defining the term "cost of sales" but I do think this approach deserves some consideration in any evaluation of the system.

Thank you very much.

[Mr. Vedder's prepared testimony follows:]

Senate Finance Committee
Subcommittee on Oversight of the Internal Revenue Service
Hearing, September 17, 1984

DO'S AND DON'TS OF TAX REFORM

By Richard K. Vedder

Professor of Economics

Ohio University

I. PROBLEMS WITH THE EXISTING SYSTEM

If an enemy power bent on destroying our nation were somehow given the opportunity to devise our tax code with a goal of sapping the nation of its economic vitality, impairing the moral fiber of its people, wasting huge resources on unproductive administration, and causing division and frustration in its people, it could do little better than adopt our current Internal Revenue Code. Our current tax system is a sad monument to a critical defect in the institutional framework of our political system, namely the ability of special interest groups to determine policies not in the public interest of the entire American population.

The American tax system is a complete mess. The current system of individual income taxation fails on all three criteria that are usually applied in evaluating taxes: administrative costs and simplicity, economic efficiency and neutrality, and equity or fairness.

With respect to administrative costs, our tax system is

absorbing an ever increasing portion of the nation's resources in the essentially unproductive activity of paying taxes. The employees of the I.R.S. are just a small tip of the iceberg. In a chapter of a forthcoming book being published by the Pacific Institute for Public Policy Research dealing with capital taxation,

I made a crude estimate of the growth of what I call the "tax army" over time. The tax army includes the employees of the Internal Revenue Service, plus half the accountants and one-fourth the lawyers in this country. In 1950, that army numbered 290,000 persons, while today it approximates 900,000 Americans, including some of the brightest minds in our country. The tax army is larger than the U.S. Army. The mere act of paying taxes costs our society literally billions of dollars every year.

The most serious administrative problem, however, is the rapidly growing problem of tax evasion. The underground economy is growing at an exponential rate. In two studies that I have done with colleagues, we demonstrate that there is a very close relationship between the marginal income tax rate paid by the typical taxpayer, and the willingness of the taxpayer to pay taxes. We all have a choice - to pay taxes or not pay taxes. When the cost of paying taxes grows too large, increasingly we tend NOT to pay them, undermining the system of voluntary assessment that has been at the heart of the American system of individual income taxation for more than 70 years. Nonpayment may take the form of tax avoidance or, increasingly, tax evasion.

In one just completed study co-authored with Phillippe Watel, we examine the relationship between the number of returns filed by the richest Americans (those with over one million dollars in income) and the marginal tax rate that is applicable. The study covered the period 1954 to 1982. There is an extraordinarily strong statistical relationship between effective marginal income tax rates and the number of returns filed. Nearly three thousand millionaires were flushed out by the income tax reduction from 70 to 50 percent as a consequence of the Economic Recovery Tax Act of 1981, and other laws reducing capital gains rates have had similar although less dramatic effects. One way to deal with the growing problem of tax evasion and excessive tax avoidance is to lower the marginal tax rates, lowering the cost to the taxpayer of complying with the intent of the Internal Revenue Code.

Problems of Neutrality and Efficiency

Volumes of very good studies have been completed demonstrating that the current tax system fails monumentally with respect to tax neutrality and economic efficiency. We all know the tax laws, given the large numbers of exclusions, deductions, credits and preferences, lead resources to being allocated to some activities that do not have as high of a social rate of return as other activities that are shunned because they do not receive such favorable tax treatment. This leads to lower productivity and economic growth. I have little to add to what has already been written and said about this problem.

I do have some evidence, however, about the overall impact on economic efficiency that high marginal taxes have. A good

laboratory for evaluating the impact of different forms of taxation is our 50 states. No two states have the same tax system, and variation in economic performance between the states can be related to variation in tax systems to see if taxes make any difference. In several studies, including one done for a sister Congressional committee, I have found that, other things held the same, that the higher a state's marginal income tax rate (for a typical taxpayer or for the highest income taxpayers), the lower the rate of growth in per capita personal income over the period 1970 to 1982. States with no income tax or taxes with a low flat rate grew up to one-third faster than states with relatively high income taxes with a large spread in the marginal rates from the lowest to the highest. Interestingly, however, there was no correlation of any meaningful magnitudes between rates of SALES taxes and economic growth. What does this all suggest? If the experience of our own states is any guide, and I strongly would suggest that it is, we can conclude that income taxation tends to reduce economic growth, and in particular income taxation that involves high marginal rates. By contrast, sales taxes do not have a detrimental effect on economic activity. This suggests that if economic growth is a primary goal, the tax system should be modified to include less reliance on progressive income taxes of the form currently levied, and more emphasis on sales or consumption taxes, or on income-type taxes with relatively low marginal rates.

Fairness Issues

Equity or fairness is a concept that is elusive to define and

involves lots of subjective judgments. What is fair to one person may seem grossly unfair to someone else. No so-called expert can show that a tax is good or bad on equity grounds since there are no objective criteria for determining equity. At the same time, scholars can present evidence on the distributional effects of taxation for others to use in evaluating tax systems according to their own individual values.

Given the fact that the taxpaying public is the ultimate judge as to the fairness of a tax system, I think it is very useful to look at evidence over time on the attitude of taxpayers to our current system of taxation. The Advisory Commission on Intergovernmental Relations has been surveying people for over a decade, and one clear trend in public attitudes has emerged. The proportion of persons viewing the personal income tax as the most unfair tax of all the taxes imposed by any level of government has over doubled. Whereas in the early Seventies people viewed the property tax as our most unfair tax, today the income tax wins that dubious distinction in a landslide. The last decade has seen our income tax become more complex and bewildering, and the effective rate of marginal taxation faced by most taxpayers has grown significantly.

The major reason, I think, that people increasingly view the federal individual income tax as unfair is that it fails miserably to meet the objective of what experts in public finance like to call "horizontal equity." Taxpayers with the same income or in the same set of economic circumstances now pay widely differing amounts of taxes. Some persons with $100,000 income

may pay nothing in taxes, others pay a few thousand dollars, while some pay perhaps $30,000 or $40,000 in taxes. Vertical equity -- fairness between DIFFERENT income groups, has not changed much over the years. What galls people is not that the maximum tax rate on high income Americans is only 50 percent, but rather than some rich Americans escape paying much taxes at all. Horizontal inequities are clearly the result of a growing prolifigation of deductions, credits, allowances, etc., as well as the growth in outright tax evasion that has created two classes of people, the hapless millions of honest Americans who pay taxes, and a smaller class of dishonest tax evaders who escape paying their tax obligations. The growth in tax evasion has greatly increased the problem of horizontal inequities, and undermined in a very serious fashion the moral fiber of the American people. The tax system is not only a economic scandal of the first magnitude, it is the cause of an increasing MORAL problem. We are becoming a nation of petty thieves and pickpockets because of the inequities and high marginal rates associated with our current system of taxation.

II. SOME "DO'S OF TAX REFORM

Any new tax system must meet at least one and preferably all three of the following objectives:

1. lower administrative costs and increase taxpayer compliance
2. achieve greater neutrality and promote economic growth

3. promote a greater degree of perceived fairness.

The two key elements in any reform is to reduce the RATE at which the tax base is taxed, and expand the SIZE of that base. When tax rates reach 40 or 50 percent, the incentives for tax avoidance are too high. Moreover, to the extent some income is excluded from the base, gross distortions in resource allocation are bound to arise. Moreover, this causes the horizontal inequities discussed earlier. With lower rates, the distortions (non-neutrality) are reduced, as are horizontal inequities and problems of non-compliance. Widening the tax base is necessary to avoid revenue loss, but in addition in itself reduces administrative problems associated with evaluating and policing legal exclusions from the base as well as horizontal inequities associated with our current Byzantine system of deductions, exemptions, credits and like.

When I talk about "tax rates" I mean MARGINAL tax rates. Marginal rates determine the amount any additional economic activity will be taxed, and they are the critical rates in influencing human behavior. Lowering marginal rates can dramatically stimulate new economic activity, as the Steiger Amendment of 1978 showed us with respect to capital gains and the Economic Recovery Tax Act of 1981

showed us with respect to economic activity generally. It is no coincidence that we are having the postwar's most robust economic recovery in the midst of phasing in the postwar's largest reduction in marginal federal income tax rates.

Interestingly, we collected far more taxes from high income Americans in 1982 than in 1981 despite the drastic reeduction in the marginal rates applicable to that part of the population. In a reccession year when overall tax revenues were down, collections from that group of the population getting a larger marginal tax reduction were acctually up. As studies by both James Gwartney and myself (both with other colleagues) show, the size of the taxable base is highly responsive to the marginal rates in effect. Our findings both suggest that in the upper income ranges in contemporary America, we are in the negatively sloped portion of the Laffer curvee; in other words, tax rate reductions have meant an increase, not decrease, in tax revenues. All of this adds support for the proposition that marginal tax rates must come down as part of tax reform. Summarizing, THE CARDINAL RULE OF TAX REEFORM IS: DRASTICALLY LOWER MARGINAL TAX RATES WHILE EXTENDING THE BASE SUBJECT TO TAXATION.

There are other things we can no doubt do in any

reform of our tax system, but these other things are almost trivial in importance compared with the need to fully achieve our paramount objective, so we must concentrate our energies on reduction of rates, to be financed in part by the expansion of the tax base, and in part by the economic growth that a more rational tax system would provide.

III. "DON'TS" OF TAX REFORM

There are more "don'ts" of tax reform than "dos", since it is easier to sin than to achieve salvation, at least in Washington, D.C. Let me speak of only two or three ones. The most critical "don't", of course, is to not impose a new "better" tax on top of the disastrous tax system we already have in the interest of "fiscal responsibility" or "deficit reduction." I am very much concerned that some persons view tax reform as merely a nifty political device to raise more money without inflicting too much political damage. There is no reform unless the old system is junked. That is not to say that the enhancement of economic efficiency under a new tax system would not lead to higher output and incomes for Americans. Thatt would happen, and would allow the goveernment to collect more revenues while burdening the population less. This would also lead to some deficit reductions. But do not undertake reform merely to

reduce deficits; concentrate on removing the inefficiencies and inequities that the current system creates.

Another "don't" is to allow the tax base to be reduced by special interest groups seeking special treatment in any discussion on tax reform. Speecial treatment leads both to a narrowing of the tax base forcing us to adopt higher rates) and leads to inequities, particularly of the horizontal kind. Once you treat one group of persons in a special way, equity and political pressures force you to treat others in a special way too, until we are back where we started. Worst, special treatment leads to a non-neutral tax system that leads some persons to engage in unproductive activities that have been made artifically productive by the tax system.

A third "don't" in reform, probably, is to continue to treat business enterprises totally separately from individuals and households. Businesses are owned by people, and ultimately only people pay taxes. As I ask my students, what army did General Motors ever lead? Clearly a desirable attribute of any tax reform is the fuller integration of business and individual entities. The double and even triple taxation of income from capital that exists in our current system is a scandal that is largely responsible for our low

rate of savings and capital formation, the major single reason why America's economic growth in the last generation is one of the lowest of the major industrialized countries. Fuller inteegration would promote efficiency and also tend to eliminate inequities. If the experts cannot even agree who bears the burden of our corporate taxation, it is highly unlikkely that the burden is distributed in a manner that serves our sense of social justice.

IV. THE POLITICAL ECONOMY OF TAX REFORM

Conventional wisdom has it that truly radical reform of the tax syatem is imposaible. The apecial interest groups and PACs will ahower retribution on any incumbent who attacks cherished tax preferences, and the elimination of those preferences is vittal to getting true reform.

As a former employee of Congress filled with a grreater sense of cynical political realism than most college professors, I am in complete aympathy with the problems that you political entrepreneurs encountered in draftting legislation. The power of PACs and lobbies is enormous and they may well be making politicians who blithely ignore them an endgangered apecies in dire need of environmental protection.

Nothwithstanding that point, I think there is some reason to hope that adoption of a wide

base-low rate tax may in fact be politically feasible. First of all, the American public's unhappiness with the existing tax system has been growing, suggesting that there is a lot of potential support for a new tax system. The one thing I simply cannot understand is why neither candidate for President is pushing tax reform as a major part of his campaign, since polls indicate that calls for such reform should be enthusiastically received by the public.

Piecemeal attempts to eliminate tax preferences in order to widen the tax base are seldom spectacularly successful given the power of the lobbies. GENERAL elimination of such preferences may actually be more attainable since what the special interests lose in tax preferences in many cases will be offset by gains from substantial rate reductions, not to mention the likely expansion in economic activity that would accompany a rationalizing of the tax system.

Let me cite one example. If you in piecemeal fashion decided to eliminate the deduction for interest income on municipal bonds, the entire investment community would fight the move tooth and nail. If, however, you eliminated that deduction as part of a tax reform that lowered marginal tax rates to 25 percent and excluded savings from the

tax base, a different situation would emerge. Some municipal bond dealers still would be incensed, but most of the investment community would see the gains from rate reductions and better treatment of savings to be greater than the losses from losing special status on municipal bonds.

The key may well be to say no to all the special interests wanting tax preferences. Tax simplification is a little bit like virginity; if it is violated once, it is gone forever. Once you open the door to one group,a sense of fairness suggests you need to give another group a break. Before long, you are back where we started. It might be better for everyone, any yield a better tax bill, if political leaders like the distinguished chairman of the Finance Committee forged a bipartisan consensus that "we are going to say 'no' to everyone."

V. ALTERNATIVE REFORM PROPOSALS

I have deliberately saved discussion of alternative tax systems until last. In my judgment, almost any of the alternative tax systems under committee consideration today are superior to the existing Internal Revenue Code. The differences in economic impact of the alternative systems, while substantial, are less significant than the difference beetween the current system and the

least desirable of the alternatives.

Unfortunately, I do not believe that many members of Congress view these alternative systems as substitutes for existing taxes, but rather as complements to the basic system. This is particularly true of the schemes that involve taxing a base conceptually quite different than the income basis not used.

The Value Added Tax (VAT)

For that reason, I am unenthusiastic about a value added tax (VAT) or a national sales tax. I suspect our political leaders view them as "new" type taxes and thus as new sources of revenue to reduce deficits. Conceptually, a reasonable case can be made for a VAT. Value added taxation involves taxing production and productive inputs, including labor and the returns (profits) to capital. While the taxation of productive acctivity almost never is desirable from a standpoint of increasing private production, a VAT tax can reduce problems of non-neutrality, of the separation of business and households, and of horizontal equity. Moreoveer, a 15 percent VAT with almost no exemptions would raise more money than current income taxes on individuals and corporations. If, however, a VAT

were imposed on top of other taxes, severe negative impacts are possible. Aside from the inflationary impact more commonly discussed, a VAT raises the marginal cost of hiring workers, raising unit labor costs which leads to a reduction in the quantity of labor demanded.At least until markets adjust, value added taxes can create unemployment. Europe in its post-VAT period has had much higher unemployment than pre-VAT, and that may not entirely be a coincidence. For VAT not to create unemployment, however, either prices must rise, causing inflation, money wages must fall, or a combination of both.

It is highly unlikely that the burden of a VAT would fall evenly on the population, and it seems less likely that a flat rate VAT would be as "progressive" as the current income tax system. While that does not bother me on equity grounds, it no doubt would bother others, such as Mr. Mondale. Given what the VAT did for Al Ulman, I suspect this tax is not the prime candidate in consideration in any reform in any case.

A National Sales Tax

Similarly, a national sales tax has many positive things about it. Administratively, the tax is relatively easy to collect and cooperative arrangements with the states would ease compliance and administrative cost problems. The tax is not

one on productive activity, and removes the anti-savings and capital formation bias in current law. At the state and local level, studies that I have done show that states that rely heavier on sales taxes tend to grow somewhat faster than states emphasizing income taxes. On equity grounds, one can argue persuasively that it is consumption, not income, that provides pleasure in life, and that it is therefore more appropriate to tax it.

At the same time, however, a national sales tax has three strikes against it. First, it is difficult to interject progressivity, which some view as important on equity grounds. Second, as mentioned before, most view such a tax as an add on to the current system, meaning there is no reform of the income tax. Third, the states have sales taxes, and would fight the national sales tax concept, arguing they have preempted this revenue source and in a sense have political "squatter's rights" on it. Moreoveer, I could not envison Congress approving a tax with a rate over 10 percent, raising at the very most $200 billion a year, far less than current income taxes. In no way would a national sales tax substitute completely for an income tax. Finally, there probably are some significant transitory inflation problems with

this tax. In fairness, however, there are transition problems with any new tax.

A Gross Income Tax (GIT)

The gross income tax or gross receipts tax has been advocated vigorously for years by Mr. Jim Jones, who I understand is now working on your staff, Mr. Chairman. It is a concept that deserves more serious attention than it is getting. In many ways it is the ultimate tax in terms of the goals of tax reform, namely radically reducing marginal tax rates and expanding the size of the tax base. It is also a tax that is classic in its simplicity and thus would ease the administrative burden and compliance problems of the Internal Revenue Service.

In its simplest form, it is a tax on the gross receipts of business enterprises. Mr. Jones suggests several variants of his scheme, one, for example, having individuals filing returns on their share of their employers gross receipts; in another variant, employers would file on behalf of their employees and there would be a substantial decline in the number of individual filings, a great blessing for both the public and the IRS.

The one deduction allowed from gross receipts is for "cost of sales", a term that means different things to different people. Narrowly defined, it would just include raw materials. Broadly defined,

it would include labor costs associated with production. In the former case, the tax would not be too different than a value added tax, while in the latter case, it would come fairly close to being a net income tax not radically different in a conceptual sense than the current tax base.

Based on the desirability of base expansion and rate reduction, I find a gross income tax with few deductions to be somewhat appealing. The ultimate gross income tax, or GIT, would have no deductions. I believe such a tax with a seven percent rate would probably raise more revenue than the existing income tax. Such a "pure" GIT, however, is not without problems. Consider the grocery store with $5 million in sales annually, and $1 million in invested capital that typically makes about $150,000 in annual profits. With a seven percent GIT, its annual tax bill would be $350,000---an enormous amount equal to 35 its percent capital and more than twice profits. To be sure, the tax would be passed on, but such a tax might impose significant short run hardships on businesses. There would be enormous incentives for firms to merge in order to avoid market transactions subject to tax, a move that might have anti-competitive implications of a serious magnitude. A GIT that allows for generous deductions for costs of sales

alleviates some of these problems, but also would have to have higher rates to compensate for the smaller base.

Finally, many would condemn the GIT approach on equity grounds, since it does not readily provide for progressivity and might be perceived to violate some persons ideal with respect to the "ability to pay" principle of public finance. Since questions of equity are so subjective, I hesitate to pass judgement on that criticism, and certainly a GIT might reduce perceived serious horizontal inequities. It is an approach with problems, as are all others, and deserves greater study.

Flat Rate and Quasi-Flat Rate Proposals

I have been an enthusiastic and early supporter of the flat rate tax movement. Elsewhere I have argued that almost all flat rate proposals are superior to the existing tax code not only on grounds of administrative costs, compliance and economic efficiency, but also on equity grounds as well, since almost all flat rate proposals eliminate or substantially reduce the problems with horizontal inequities (persons with the same income paying substantially different amounts of tax.) The rise in the unpopularity of the current income tax coincides with a growing deviancy of that tax from the principles incorporated in flat rate taxes.

The move upward in the typical marginal tax rate paid by Americans has not only bred disenhancement, but it has meant that the disincentive effects of high marginal rates are influencing many Americans, not just a few rich. The ratio of the prevailing marginal rate to the average rate has also grown over time, an undesirable attribute given that marginal rates have distinct disincentive effects that reduce the quantity of available resources and thus total output.

It is important to remember that most so-called "flat rate taxes" are not flat rate at all, but instead merely have less rate progressivity than the existing law. Also, some of the flat rate proposals effectively are consumption taxes, that is taxes that exclude savings from the tax base. A relatively "pure" flat rate proposal is that of Hall and Rabushka; it can be filed on a postcard, has virtually no deductions, and has only one rate applicable at all income ranges. Going to the other extreme, the Bradley-Gephardt proposal has several income brackets, permits several deductions, and would require filling out a form of moderate length.

Any of the major schemes proposed would improve on the existing system but there are differences. Bradley-Gephardt is probably more progressive than

Hall-Rabushka, which may be good or bad depending on your system of values. Hall-Rabushka is superior in terms of simplifing forms and putting lawyers and accountantss to more productive activity, as there is virtually no possibilities for tax gamemanship with their proposal. Their proposal also would probably involve a rate of 20 percent or less, while Bradley-Gephardt has a maximum rate that reaches 30 percent. Hall-Rabushka has complete integration of business and individual taxation, while Bradley-Gephardt has very little integration, although the sharp reduction in corporate tax rates under Bradley-Gephardt would reduce very sharply the problems of double taxation of returns from capital. Kemp-Kasten is somewhere in between Hall-Rabushka and Bradley-Gephardt. For example, while the maximum rate on Hall-Rabushka is about 20 percent (they originally proposed 19 percent), and Bradley-Gephardt is 30 percent, Kemp-Kasten is exactly in between at 25 percent.

In keeping some politically popular deductions, some of the quasi-flat tax plans create some economic problems. Let me cite just one example. Under Bradley-Gephardt, state income taxes are deductible against income but sales taxes

are not. Presently, both types of taxes are deductible. By eliminating the sales tax deduction but not the income tax one, the Bradley-Gephardt bill provides some incentives for the states to increase income taxes but lower sales taxes, as that would lower the federal tax liability of citizens under Bradley-Gephardt.

So what? To begin with, that makes the federal system non-neutral with respect to the taxing decisions of states. More importantly, there is substantial evidence that high income tax states grow slower than low income tax ones, while sales taxes do not have that debilitating impact. The bias created by Bradley-Gephardt works in the direction of favoring taxes that are in fact growth-inhibiting, mainly because the favored taxes reduce rates of return on human and physical capital investment, retarding resource growth. While the magnitude of the problem is probably not really that substantial in this case, it does suggest there are pitfalls in trying to retain certainly politically popular deductions at the expense of others.

In short, I prefer a "purer" flat rate proposal of the Hall-Rabushka variety to the less radical bills like Bradley-Gephardt. Kemp-Kasten is somewhere in between. Yet while I think

Bradley-Gephardt is a vastly inferior bill to either Kemp-Kasten or Hall-Rabushka, it is also superior to the system we currently have. Even with Bradley-Gephardt, we would have a major reduction in the disincentive effects associated with high marginal income tax rates, we would have some reductions in problems of horizontal inequity, and we would probably ease some administrative problems, including the growing problem of noncompliance with the tax laws.

VI. SOME CONCLUSIONS

Deficit reduction is desirable, but it would be a tragedy if we look at alternative taxes mainly as a means of lowering deficits, ignoring the tremendous loss of efficiency, and the large administrative burdens, that the current tax code promotes. There are differences worth debating between various alternative tax schemes. There are transition problems with all schemes, problems that I have not materially touched upon. However, our current tax system is so burdensome in an economic and moral sense on our country that nearly all the alternatives represent an important improvement over the existng system. As we consider tax policy in the coming year, let us be bold and replace our current tax system, a system that is costly to administer, is widely evaded, promotes wildly inefficient and antiproductive economic behavior, and is increasingly viewed as quite unfair. Thank

Senator GRASSLEY. First of all, do you all accept the premise, then, which one or two of you spoke to, that changing the tax system, getting the marginal rate down, getting at the underground economy, improving the credibility of the system particularly with the middle-income taxpayer, are necessary prerequisites regardless of what we do on enforcement to have greater compliance?

You have spoken to it, but I just want to get a summary of that point now.

Mr. TATUM. Well, let me reiterate what has been said earlier. I believe I agree with the statement you just made, that compliance could be enhanced by first of all making the system simple, and perhaps most of all by making it fair, or at least making the people feel it is fair.

Right now we are dealing with just the opposite—a system that is very complex and which most people feel is unfair. They are never sure if they have taken advantage of all of the deductions and credits that they are entitled to. They are really bewildered by the whole system. They feel compelled to go to a professional, and a lot of times the professionals don't agree on what is the best advice.

You know, what we have now and what we have been working with is just a kaleidoscope of constantly changing rules and regulations that are beyond human comprehension. And you know a small accountant like me—I can't comply with the Code. It's too complex. It's beyond my ability to work with. So accountants are developing their own system of justice.

Now, going back to your original question I think, if you make it straightforward, fair, and simple, people are going to tend to comply with it.

Now, we have got another problem that is really not talked about here today, and that is the amount of money that the Government spends. A lot of people resent the amount of tax they pay; nobody really wants to support the mammoth amount of Federal spending that goes on. But I think the bullet or the pill would be a little easier to swallow by the public if they felt it was fair and if you gave them the opportunity to pay their share of the cost of Government every month just like they pay the rent. I mean, we all pay our rent, we all pay for our groceries, we do it every month. We don't try to beat the system—the system doesn't give us the opportunity to beat it. The net income tax system gives us, still, a lot of opportunity to beat the system and to protect ourselves from what we feel is wasteful, abusive spending by Government.

Senator GRASSLEY. Mr. Vedder?

Mr. VEDDER. I agree with what your assessment was earlier. If you cut the marginal rates, you are going to go a long way toward taxpayer compliance. That isn't to say, of course, that the number of IRS agents is irrelevant, but it is not the major way to move toward increasing compliance, in my judgment.

Senator GRASSLEY. Mr. Kent?

Mr. KENT. Yes.

I think that we have developed in this country what I have called "a new cult of entrepreneurship which is paper entrepreneuralism." That means that instead of going out and producing

new products and developing new technologies, trying to meet consumer demands, lowering cost of production, what today's entrepreneurs are doing is trying to discover the loopholes in the Code, because that is the way you can make the most money. You can maximize the bottom line not by benefitting society but by figuring out some way to exploit some of these loopholes and tax advantages that are there. The people that are making the money are those who can afford enough specialized expertise, to find out what those paper entrepreneurship opportunities are and to use them. Anytime you reduce the benefit which is involved in engaging in paper entrepreneurship, you will get more real entrepreneurship.

Senator GRASSLEY. One of you did address the issue of transition from one tax to another, from our present income tax I guess to the gross income tax. That individual, and I forget which one it was, may want to address transition from that to the other forms of taxation we have been talking about. And I guess the main thing I would like to have the rest of you address is that issue as it affects any of those taxes and whether or not the extent to which that is a serious problem. I see getting from here to there as a very serious problem, regardless of all of the very optimistic and beneficial aspects of any alternate tax system we have been talking about.

Mr. TATUM. Well, I see a conversion from the net income tax system to a gross income tax system as a very positive thing in the eye of the public. To convert from a net income tax system to a value-added tax or some of these other tax proposals, it would seem to me, would be very complex. I don't think the public would see that as very positive. I think it will be just more confusing, more complex, more people just have to go to their accountant or their lawyer and say, "What does all this stuff mean? Tell me how I can"—you know, in this maze of complex provisions—"tell me how I can defeat this system."

I think if you don't make it simple, you are going to fail.

Senator GRASSLEY. Now, you spoke to the fact that it is necessary to do it, but what about the practical problems going from a net income tax to a gross income tax as fairly simple, but do you see the problems insurmountable in any of these areas of transitions from one to the other?

Mr. TATUM. Well, I just feel that the other areas that you talked about seem more complex. Now, the national sales tax has some merit, but I think that shifts too much of a tax burden to the people who spend most of their income to purchase cost of living. People at the higher end of the economy who can live off 10 percent or 20 percent of their earned income would probably pay less tax and would get by paying less. Also, I don't think the national sales tax gives you the opportunity to provide credits or incentives to stimulate the economy. A gross income tax would still give you the opportunity to provide employment incentives, capital investment incentives, self-retirement incentives. I don't know how a national sales tax, which is collected at the point of sale, gives you the opportunity to stimulate the economy in that way.

Senator GRSSSLEY. Mr. Vedder?

Mr. VEDDER. I am not an expert on tax administration. I am not entirely unconvinced that one couldn't go cold turkey from one

system to another, but I do admit that there would be significant inequities created. The young family who just bought a new home and has enormous mortgage payments, anticipating long-range future deductions on those, would feel very grieved, I'm sure, if we phased out the mortgage deduction as part of any reform. That may be sacrosanct and can't even be talked about—I don't know. But for that reason, I guess I would think that one could phase in a system in a period of 5 to 7 years, where one essentially reduces existing deductions by, say, 20 percent a year, and at the same time lowering rates to compensate for the growth in the base, ending up with some system 5 years down the line. Now, that applies more with regards to something like a flat-rate income tax than it does the gross income tax concept; but if you were going to go to something like Bradley-Gephart or Kemp-Kasten, I would think that it could be done.

I am not an expert on that, though. I haven't thought it out completely. I admit there would be significant problems, but I think it can be done.

Senator GRASSLEY. Mr. Kent?

Mr. KENT. I think that there would be very significant transition problems. That doesn't mean we shouldn't have a complete overhaul of the tax code, but I do think that these transition problems would create very real hardships that we don't want to inflict, not just these hardships would be on families with high mortgage interest deductions that they have now, but on businesses which have taken deductions, and have set up an investment program expecting to depreciate a very significant amount of their assets. Unless you allow them somehow or other during this transition period to compensate for the tax advantages they thought they were going to have when they made the investment, then you would certainly, I think, devastate a very large percentage of your business community.

The transition period that you are looking at doesn't have to be as long as 30 years, as some of the witnesses before your committee in your spring hearing indicated, but I think you would have to look in some instances at transition periods as long as 10 to 15 years before you would be able to fully implement any of these new flat tax programs.

That doesn't mean we shouldn't do it, it just means that we have to be realistic about how difficult it would be, considering the tax preferences that are there, that people have legitimately made decisions on the basis of those preferences. It would be unfair to them to disrupt their business and personal lives by snatching those away from them.

Senator GRASSLEY. All right. That's all the questions I have, but let me remind you as well as the previous panel that I forgot to mention that maybe other committee members who weren't able to be here today because of their schedules may have questions that they will submit in writing, and also that the record will be open for a few days, like maybe 15 days, so that you can submit any additional testimony or make any corrections in the record that you feel necessary to make.

Thank you all very much, and that's the end of this series of hearings.

[Whereupon, at 11:45 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

MR. CHAIRMAN, My name is Edward A. Ellison, Jr. of Baltimore, Md, and I would like to thank this Committee that my request to testify on behalf of the American people, to provide input to this committee has been honored.

The subject of taxation, which is before this committee, is perhaps of no less importance today than it was over 200 years ago when oceans of blood were spilled by a people who freed themselves from many of the sufferings of which todays people complain.

Let us not forget in our discussion on taxation, the blood spilled during the Revolutionary War . . . for it was this sacrifice which today allows this public hearing on taxation to take place, and the will of the people to be heard by their elected representatives.

During the past several years I have travelled across the United States and have been fortunate enough to meet with citizens from almost every station in life. I have lectured on the topic of taxation before audiences composed of businessmen, manufacturers, farmers, individual entrepreneurs, and just plain ordinary folks who live by the sweat of their labor.

I was inspired to learn during my travels, that the people across our nation are not as divided in their views, when it comes to taxation, as portrayed by todays political pundits. The common thread which I am happy to report to this committee, which binds our nation's people, is one of honesty, for they have been quick to support with vigor, the honest system of taxation which our founding fathers wrote into our Constitution - that is, after they have been educated to this system which has been curiously overlooked, or purposely ignored by the peoples elected representatives.

The very fact that a special hearing on taxation is now in progress, and countless points of view have been stated before this committee by special interest groups seeking to extricate themselves from an obviously inequitable system of taxation, is evidence that a tax on earnings is not only patently oppressive, it is destructive to the general welfare of our nation.

During the first Congress of the United States, 1st Session, April 8th, 1789, Mr. James Madison, speaking before the House of Representatives which enacted our nation's first Revenue Raising Act, stated:

> ".....a national revenue must be obtained; but the system must be such a one, that while it secures the object of revenue it shall not be oppressive to our constituents. Happy it is for us that such a system is within our power, for I apprehend that both these objects may be obtained from an impost on articles imported into the United States."

Gentlemen, it is within this Committees power to promote a system of taxation which is not oppressive upon the people of the United States, nor any of the special interest groups in attendance at this hearing. All that is needed, is a desire to do so.

It is a commonly accepted fact that a tax upon the earnings of our nation's labor, manufacturers, agricultural industry and small businesses is a tax upon production. That, a tax upon production stifles a free exchange between labor and industry; impedes America's ability to produce; increases the price of our articles exported; which in turn is destructive to America's ability to compete in

foreign trade, and thus, a tax based upon earnings is not only oppressive, it is not in the best interests of the United States.

To obtain a national revenue, from which to discharge the national debt, provide for our nation's common defense and fund those constitutionally authorized objectives which are enumerated in our Constitution, it is imperative that this committee take note of the 1st Congress of the United States which enacted our nation's first revenue raising act.

This Act opened with a stately preamble spirited by patriotism, responsibility, the love of freedom, and a sincere desire to bring prosperity to America through an America First Policy:

> "Whereas it is necessary for the support of government, for the discharge of the debts of the United States, and the encouragement and protection of manufacturers, that duties be laid on goods, wares, and merchandises, imported ..."

In agreement with the wisdom of our founding fathers and in the interests of the United States general welfare, it is essential that all federal revenue currently raised from the earnings of Americas labor, agricultural industry, manufacturers, and small businesses be suspended, and necessary revenue be raised from other sources, to wit:

(1) That articles of consumption, both domestic and imported, such as cigarettes, spiritous liquors, jewelry, (articles of consumption which are of a purely luxurious nature) ought to have an inland excise tax added to their consumption; taking into account the price of similar articles imported, and adjusting this tax on each specific article so both may

compete in our market on a fair and equal basis, while bearing in mind that an excessive tax upon such articles will reduce consumption and diminish a just source from which to fill the national treasure.

(2) Imported goods which are not of a purely luxurious nature, which can be, or are manufactured in America, ought to be taxed with a view to encourage and protect American manufacturers, while promoting f a i r trade, as opposed to f r e e trade. The principles to be taken into consideration in the selection of those imported articles to be taxed, and the rate at which each imported article ought to be taxed are these:

(a) Imported articles which are produced by slave labor (produced in a labor situation in which the inalienable right of the individuals to contract out their own labor as they see fit being denied them without just cause) should be taxed in order to protect the standard of living enjoyed by Americans as predicted by the Framers and made possible by the obedience to our Constitution by our elected officials.

(b) Articles of consumption such as steel, aircraft, computers, vehicles used to facilitate internal and external commerce, tools of production, farm equipment, military provisions, etc., (all being necessary to the internal strength of our nation) ought to be taxed when imported, with a view to encourage and protect domestic manufacture of such articles. ~~Imposts and duties upon imports in this~~

class are justified upon the principle of national security; that the United States must never become so dependent, or interdependent upon foreign manufactures as may weaken our internal manufacturing capabilities as would endanger our nation's general welfare if foreign trading partners should suddenly become hostile toward America, or intimidated by other hostile foreign powers.

(3) In addition to the above mentioned taxes on consumption, a tonnage tax upon the freight of foreign vessels inporting articles of consumption is a proper method to: a) regulate trade with foreign nations; b) secure a national revenue; c) encourage the growth and protection of American owned carriers which are employed in foreign trade; d) protect American manufactures from unfair trade.

Vessels and aircraft employed in foreign trade being built in the United States, and belonging wholly to a citizen or citizens thereof, ought to be given a preference at our ports of entry. The principle upon which a tonnage tax upon the freight of foreign carriers ought to be imposed must take into account the nations with whom America trades; their policy on import taxation upon articles of consumption which America produces for export and any preference these foreign nations may give to carriers over our nations carriers at their ports of entry.

Applied properly, such a tax will provide a source from which to draw a national revenue; will greatly enhance a fair —

trade between American and foreign nations, particularly those nations exporting into our country virtually duty free, but are quite protective and discriminatory when it comes to accepting America's exports on an equal footing. This tonnage tax upon the freight of foreign imports will also provide a necessary mechanism to protect America's vital manufactures which is essential to America's internal strength.

(4) An internal tax, not mentioned above, and proper in its application is an excise tax upon domestic carriers when employed in interstate commerce, but, only justified in certain and limited cases: a) to insure safe passage of carriers as they pass from state to state (i.e. federal jurisdiction to prosecute and penalize hi-jackers, pirates, etc.,); b) inspection for contamination of food stuffs and raw agricultural produce; c) safety measures for hazardouw materials being shipped from state to state.

The principle justifying the above described tax is not one of raising revenue, but rather, only to raise necessary funds to pay for the cost of federal policing of interstate commerce as above mentioned. . . be it understood that each carrier is to bear its own just proportion as related to the cost of federal services rendered as applicable to the specific policing protection afforded. No other kind of federal tax upon interstate carriers can be justified, and as such, all other federal taxes which now increase the cost of interstate commerce and increase the cost of articles of consumption; are oppressive to production; damaging to United States competition in foreign trade, and ought to be

immediately suspended.

Having expounded somewhat upon the method of raising a national revenue as adopted by our founding fathers, an America First policy, enacted during the First Congress of the United States, I would like to focus attention upon taxation as it applies to a balanced federal budget and the retirement of the national debt.

I have also furnished to members of this committee a bulletin which has been widely circulated by Lieutenent Colonel, U. S. Army retired Archibald E. Roberts. This bulletin contains a documented article titled "A SECOND CONSTITUTIONAL CONVENTION, WILL IT HAPPEN? ! " I have co-authored this article to expound upon the method by which our founding fathers agreed to pay off the debt of the Revolutionary War, and insure that a balanced budget would be maintained in the future by subsequent Congress' elected to manage the financial affairs of our national government.

In respect to a "Balanced Budget- Tax Limitation Constitutional Amendment," which is the title of Senate Report No. 97-151, 97th Congress 1st Session, pages 7,16,19 and on several other pages, it is acknowledged by the Senate Committee on the Judiciary that indeed, a requirement for a balanced budget exists in our Constitution! However, this Senate Report has failed to detail for the reader the Constitutional procedure for balancing the federal budget. Had this procedure been included in the Senate Report No. 97-151, it is quite obvious the subversive and fraudulent nature of the balanced budget amendment promoted by Senate Report No. 97-151 would have been exposed, along with the fraudulent call for a Con-Con to balance the federal budget.

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The third item which I have included in my report to this committee is a brief review of the debates which took place among those enlightened and sincere representatives who authored the First Revenue Act during the First Congress of the United States. Not only did these gentlemen carry out an America First Policy, and were able to solve the very economic sufferings which our nation now experiences, but they were able to accomplish this without taxing or oppressing America's labor, businessmen, or manufacturers. They accomplished their ends by simply following the principles set forth in the Constitution of the United States of America.

I have affixed to these remarks in the Appendix, a document titled PROSPERITY RESTORED THROUGH THE STATE RATE TAX of which I was the co-author. I have also included in the appendix a summary of research of the Sixteenth Amendment which may reveal to this committee for the first time the documented legislative history that the Sixteenth Amendment as passed by the Congress and ratified by the states has not given any new power of taxation to the Congress of the United States. Its power to reach (through Article 1 Section 8 Clause 1) the profits of corporations by laying a tax on the corporate charter, the tax to be measured by the amount of income produced by the corporation using that charter, or to tax the licenses of lawyers, or to tax the ill-gotten gains of criminals - has never been disputed. But for Congresses to have perpetrated a fraud upon the American people in extending the expired "Victory Tax" from World War II and using the awesome, oppressive, despotic, dictatorial power of an agency known as the I. R. S. to intimidate and make fearful American citizens in order that their property be extorted from them under the guise of

paying their "fair share" of taxation to support the government - the Congress of the United States has never been granted a power to tax the people or their property directly unless apportioned. This is proven by Article 1, Section 2, Clause 3, and Article 1,Section 9,Clause 4 of the Constitution which have never been repealed; the Congressional research service, operating for the benefit of our lawmakers through the Library of Congress; through its representative, Mr. Howard Zuritzky, has prepared a report in which he concurs with the research that has been done by myself and others in this country, that notwithstanding the Sixteenth Amendment - there is NO POWER to lay a direct tax upon any individual or upon the property of any citizen of the United States unless it be apportioned according to representation. As was practiced in the past, when the direct tax of 1798, the taxes of 1813, 14, 15, 16, & 17, and the direct taxes of 1861 were laid, in order to reduce the war debts- the war debts of the Revolutionary War, when the debts of the States were assumed by the federal government, then the taxes laid to pay for the cost of the War of 1812, and in 1861 when a direct tax was laid to pay for the cost of the Civil War, only the Northern States paid or were collected from, since the Southern States were in rebellion. In 1891, the Congress recognizing the disproportionate burden of the Northern States to have contributed to the direct tax of 1861 - they refunded to those States that had paid or from whom the tax had been collected, the amounts tendered or received. In 1894 when an attempt was made to lay a direct tax without apportionment - that tax was struck down by the court in the Pollack case - and the Pollack case is still the rule today. Notwithstanding the Sixteenth Amendment.

In the Brushaber and Stanton cases, the Supreme Court articulated that if a tax is direct - it must be apportioned. Therefore, by its own language the Sixteenth Amendment indicates it was a tax not subject to the rule of apportionment, thus it must be subject to the only other rule in existence - that of the rule of uniformity which is applicable only to Indirect Taxes. The Sixteenth Amendment applies to a tax - an indirect tax in the form of an excise tax - therefore it is not applicable against ANY American citizen who works for a wage, salary, fees, commissions, etc., exercising his constitutionally protected right to earn a living.

This fraud and practice by the government must cease. But it will take the effort of an informed Congress to end this evil practice against the citizens of the United States. The present proposals before this Congress of a FLAT RATE TAX, a GROSS INCOME TAX, as proposed by Jim Jones, Kemp-~~Roth~~ Kasey bill, the Bradley-Gephardt Bills would only extend evil practice of the I.R.S. and not follow Constitutional Taxation unless these bills are identified as applying only against lawyers, corporations, or criminals as does the Sixteenth Amendment, (which is only the redundant expression of Article 1, Section 8, Clause 1 of the Constitution). The present proposals before the Congress, such as the Flat Rate Tax, A Gross Income Tax, A Value Added Tax, A National Sales Tax are further abuses on the American people as the Congress no doubt by now, has become aware of the fact that American citizens are doing their own research to learn the present practice of taxation is foreign to any intent of taxing authority to be granted to the Congress of the United States against its citizens. There is, according to the I. R. S., a movement

throughout the country whereby people are no longer voluntarily filing "tax-returns" having learned that this is the only way authority over themselves and their property can be granted to the I.R.S. - i.e. by their voluntary submission of a signed 1040. We have heard the word "underground-economy" which again is a demonstration and application of Orwellian language whereby in effect what is truly meant is that because of drug taffic and other illegal activities, prostitution, gun-running, or whatever, that there is an under-world economy since the Congress has the power to tax with one statute that which is made criminal by another. But there is no underworld economy whereby people engaging in an exchange of their labor, which is their property, for money - which is the property of another - and therefore incur for themselves no tax responsibility to the United States government. Jefferson's inaugural address explained quite clearly that in his mind the sum of good government was one that would not take from the mouth of labor the bread that it has earned. It was NEVER intended in the formation of this country that any man should be taxed by his government upon his sweat. We hear this myth that a person only pays their fair share. Since this government was only created and given limited powers, and one of those powers was to provide for a Navy, a military force to protect us against hostile nations - this Union was formed therefore, to protect our liberty. How then, could one man's liberty cost any more than anothers? Where was this country founded upon any such principle - that the more productive a person may be - the more fortunate a person may be because of the productivity of his ancentors - that he was responsible to provide greater support to the government for the protection of his or her liberty?

By following the method of taxation employed by our founding fathers from the inception of this government, we will find that those people who are the wealthiest, and who buy more luxuries than anyone else will pay a greater proportion of taxes by the manner and frequency in which they spend their money. The Flat Rate Tax (with graduations), the FAST Tax, and the Gross Income Tax (Jim Jones - author) proposals is an attempt to change the definition of "Income", to permit the taxing of American sweat. The Supreme Court definition of income does not include the wages, salaries, fees, or compensation for services for unenfranchised Americans who have exchanged their labor (property) for money (property) in the pursuit of their constitutionally protected right to earn a living.

Congress cannot define income. The U.S. Supreme Court has held:

> ...it becomes essential to diatinguish between what is, and what is not"income"...Congress may not, by any defintition it may adopt, conclude the matter, since it cannot by legislation alter the Constitution from which it alone derives its power to legislate, and within whose limitations alone, that power can be lawfully exercised.
>
> Eisner v. Macomber, 252 US 189 (1920)

The sixteenth amendment allows an "excise tax" only on "gains" and"profits" earned through the exercise of a government granted privilege or criminal activities.

Present IRS interpretations are actually directed towards collecting a direct tax on both the source and the income, in regard to all forms of compensation, when the law allows only for an indirect tax in the form of an excise upon income.

The misapplication of the law practiced by the IRS with the tacit approval of the Congress and the Judicial system permits governmental rape of the personal and business finances of America.

Are we supposed to be of good cheer that the Congress is looking into new proposals for the collecting of taxes? Is the action of the Congress arising from a concern that the tax system is unfair and oppressive? Or is it because more and more Americans are becoming informed that they don't owe an income tax and are walking away from economic slavery despite the threats and abuses of the IRS?

The Congress promises tax reform. The dictionary reminds us that "reform" is an attempt to correct that which was corrupt from the beginning.

It matters not whether the conditions that exist are the intentional or accidental fault of the members of Congress. They have taken an oath to uphold the Constitution and obey it and they are in violation of that oath in many ways and not just in matters of taxation.

For months we have heard that any plan now proposed, if adopted must produce the same amount of taxes at a minimum. This does not take into consideration the vast expenditures of monies for objectives for which there is no constitutional authority whatsoever. This monetary goal demonstrates the total lack of concern by the Congress to restrict itself to spending only as constitutionally authorized.

The Congress is guilty of permitting the IRS to criminalize citizens who only want to protect their property from a confiscatory government.

It is the present membership of the Congress that needs to be

replaced and not a tax collection system. Impeachments should be sought against those who continue to violate their oaths of office and those who are currently standing for office should be struck down at the polling booths.

We have Senators who have been better educated in the provisions of Parliamentary government such as that practiced in England than have been taught the intent of the Framers who wrote the Constitution, the Law of the Land.

The best thing to come out of Washington in many decades is the Grace Commission Report and that contains sufficient evidence of the abuses of the Constitution concerning fiscal practices of the stewards of government.

The Congress is supposed to be composed of our public servants and not our masters. Other abuses of the Constitution and violations of trust will be addressed in my soon to be published book, " Congress In Rebellion".

In closing may I remind this committee that over fifty years ago, Will Rogers said, "There is no organized crime in the United States except for the Congress of the United States.", and I submit that the criticism is still valid today.

Gentlemen, the plan for taxation which I submit before this committee is in fact, the Constitution of the United States of America.

Respectfully submitted,

Edward A. Ellison, Jr.

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APPENDIX

1. An America First Policy
2. A Second Constitutional Convention, Will It Happen?
3. Prosperity Restored Through The State Rate Tax.
4. Balanced Budget in Constitution - Article published in SPOTLIGHT 3/26/84

AN AMERICA FIRST POLICY

by:

Edward A. Ellison, Jr.
and
John William Kurowski

It is a commonly accepted fact, that a tax upon the earnings derived from our nation's labor, manufactures, agricultural industry and small businesses, is a tax upon production; that a tax upon production impairing a free exchange between labor and industry increases the price of our articles exported; that an increase in the price of our nation's exports is destructive to America's ability to compete in foreign trade, and thus, a tax based upon the earnings of production is not only oppressive, it is not in the best interests of the United States.

To obtain a national revenue, from which to discharge the national debt, provide for our nation's common defense and fund those constitutionally authorized objectives which are enumerated in our Constitution, and, which *" shall not be oppressive to our constituents"*, it is imperative that all federal revenue currently contributed by America's labor, agricultural industry, manufactures, and small businesses, calculated from their earnings, be suspended, and necessary revenue be raised from other sources, to wit

(1) That articles of consumption, both domestic and imported, such as cigarettes, spiritous liquors, jewelry,

...icles of consumption which are of a purely luxurious ...ure), ought to have an inland excise tax added to their ...sumption; taking into account the price of similiar art-...es imported, and adjusting the tax on each specific art-...e so both may compete in our market on a fair and equal ...is, while bearing in mind that an excessive tax upon ...h articles will reduce consumption and diminish a just ...rce from which to fill the national treasury. A tax up-...articles of this nature *(luxury)*, allows each person to ...tribute to government by the manner and frequency with ...ch he spends his/her money.

(2) Imported goods which are not of a purely luxu-...us nature, which can be, or are, manufactured in ...rica, ought to be taxed on their import with a view to ...ourage and protect American manufactures, which will ...note *fair trade*, as opposed to *free trade*. The princi-...s to be taken into consideration in the selection of ...orted articles to be taxed, and the rate at which each ...rted article ought to be taxed, are these:

(a) Imported articles which are produced by slave ...r (*a labor situation in which the inalienable right of ...viduals to contract out their own labor as they see ... is denied them without just cause)* ought to be taxed to ...ect the standard in our country which guarantees each ...zen's freedom to contract out their labor. Failure to ...se a tax on imported articles produced by slave labor, ...ot only unfair to our nation's labor, *but will leave ...nation's manufactures in an unfair competitive situ-...n.*

(b) Articles of consumption such as steel, aircraft, computers, vehicles used to facilitate internal and external commerce, tools of production, farm equipment, military provisions, etc. *(all being necessary to the internal strength of our nation)* ought to be taxed when imported, with a view to encourage and protect domestic manufacture of such articles. Imposts and duties upon imports in this class are justified upon the principle of *national security; that the United States must never become so dependent, or interdependent, upon foreign manufactures as may weaken our internal manufacturing capabilities as may endanger our nation's general welfare if foreign trading partners should suddenly become hostile toward America, or intimidated by other hostile foreign powers.*

(3) In addition to the above mentioned taxes on consumption, a tonnage tax upon the freight of foreign vessels importing articles of consumption is a proper method to:

(a) regulate trade with foreign nations;
(b) secure a national revenue;
(c) encourage the growth and protection of American owned carriers which are employed in foreign trade;
(d) protect American manufactures from unfair trade.

Vessels and aircraft employed in foreign trade being built in the United States, and belonging wholly to a citizen or citizens thereof, ought to be given a preference at our ports of entry. The principle upon which a

·um certain (annual deficit), and each State will be requir-
·d to contribute a share calculated upon its number of
·epresentatives (votes) in the House of Representatives.
·he tax is to be used only if imposts, duties and excises
·ail to meet Congress' annual expenditures.

Upon imposition of the State Rate Tax, the Secretary
·f the United States Treasury, to extinguish an annual
·eficit, would submit a bill to each state's capitol for
·ts apportioned share of this deficit. Each state would
·e left free to raise its apportioned share within a time
·pecified by Congress. In the event there is a surplus
·f money in the United States Treasury at the close of a
·iscal year (i.e. ther is no deficit), this surplus would
·e applied to a *sinking fund* to reduce or extinguish the
·ational debt. If there is no deficit, nor a national
·ebt, any surpluses raised from imposts, duties and excise
·axes may be returned to the states by the same rule of
·pportionment.

·d. Note. A copy of "Prosperity Restored by the State
·ate Tax" may be obtained by contacting authors.

FORMULA FOR COMPUTING EACH STATES' APPORTIONED SHARE OF DIRECT TAX

$$\frac{\text{States' No. of Representatives (votes) in House of Representatives}}{\text{total number of Representatives in House of Representatives}} \times \text{amount needed, not fundable by federal indirect taxes (imposts, duties, excises)} = \text{States' share of S.R.T.}$$

MATHEMATICAL COMPUTATION FOR THE STATE OF MARYLAND FOR A $ 100,000,000 DIRECT TAX APPORTIONED AMONG THE STATES (STATE RATE TAX)

$$\frac{\text{Md's No. of votes in House of Reps.}\ 8}{\text{total No. of Reps. in House of Reps}\ 435} = 1.839 \times \$\ 100,000,000. = \$\ 1,839,000.$$ Maryland's share of apportioned tax

The following chart shows the current rate of apportionment for a few States. This chart demonstrates each States' obligation under the State Rate tax, or, the returnable amount due to the State if federal indirect taxes have exceeded the annual expenditures of Congress. The chart is based upon a $100,000,000. returnable surplus, or the same sum certain to be laid as an apportioned direct tax:

STATE	NUMBER OF REPRESENTATIVES (votes in Congress Assembled)	APPORTIONMENT RATE OF TAX OR AMOUNT TO BE REFUNDED
Alabama	7	1.609 % = $ 1,609,000.
California	45	10.344 % = $10,344,000.
Delaware	1	.229 % = $ 229,000.
Illinois	24	5.517 % = $ 5,517,000.
Maryland	8	1.839 % = $ 1,839,000.
Missori	10	2.298 % = $ 2,298,000.
New York	39	8.965 % = $ 8,965,000.
West Virginia	4	.919 % = $ 919,000.

NOTE: Under the rule of apportionment, Washington, D.C. not being a State, and not having a vote in Congress, is not subject to the State Rate Tax.

tonnage tax upon the freight of foreign carriers ought to be imposed, must take into account the nations with whom America trades; their policy on import taxation upon articles of consumption which America produces for export; and any preference these foreign nations may give to carriers over our nations carriers .

Applied properly, such a tax will provide a source from which to draw a national revenue; will greatly enhance a fair trade between America and foreign nations, particularly those nations exporting into our country virtually duty free, but are quite protective and discriminatory when it comes to accepting America's exports on an equal footing. This tonnage tax upon the freight of foreign imports will also provide a necessary mechanism to protect America's vital manufactures which is essential to America's internal strength.

(4) An internal tax, not mentioned above, and proper in its application, is an excise tax upon domestic carriers when employed in interstate commerce, but only justified in certain and *limited* cases:

(a) to insure safe passage of carriers as they pass from state to state (i.e., federal jurisdiction to prosecute and penalize hijackers, pirates, etc.);

(b) inspection for contamination of food stuffs and raw agricultural produce;

(c) saftey measures for hazardous materials being shipped from state to state.

The principle justifying the above described tax is not one of raising revenue, but rather, only to raise necessary funds to pay for the cost of federal policing of interstate commerce as above mentioned . . . be it understood that each carrier is to bear its own just proportion as related to the cost of federal protection rendered as applicable to the specific policing service afforded. No other kind of federal tax upon interstate carriers can be justified, and, as such, *all other federal taxes which now increase the cost of interstate trade, increase the cost of articles of consumption; are oppressive to production; damaging to the United States in the competition for foreign trade, and ought to be immediately suspended.*

Having offered an *America first policy* by which to raise a national revenue, *beneficial to America's labor, manufactures, agricultural industry and small businesses*, the question remains as to the retirement of the national debt.

Under the proposed plan, if the annual expenditures of Congress exceed the revenue raised from imposts, duties and excises, then, *Congress shall* impose the *State Rate Tax* in order to preclude Congress from adding a year end deficit to the national debt.

The State Rate Tax is a direct tax required to be imposed if an annual deficit occurs. This tax is to raise

BULLETIN

COMMITTEE TO RESTORE THE CONSTITUTION™

CRC

#855

Archibald E. Roberts,
Lt. Col., AUS, ret., Director CRC

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SECOND CONSTITUTIONAL CONVENTION

CITIZENS PETITION FOR REPEAL OF MARYLAND'S CALL FOR CONSTITUTIONAL CONVENTION

Rescinding Maryland's call for a Constitutional Convention to balance the Federal budget is the goal of Edward Ellison and John Kurowski who lead a State petition drive to defend and preserve the Constitution of the United States.

By complying with emergency taxing power in the Constitution, Article 1, Section 2, Clause 3, they say, Federal lawmakers can immediately affect an annually balanced Federal budget without the risk of a constitutional convention.

Fearing loss of freedoms of person and property posed by the constitutional convention syndrome, a growing body of alarmed citizens ask for a review of their State involvement in the balanced budget stampede.

The emotionally-charged issue, hysterically promoted by the National Tax-payers Union, 325 Pennsylvania Avenue, SE, Washington, DC, and other groups fronting (knowingly or unknowingly) for world government advocates, may result in replacing the Constitution of the United States with a soviet-style Constitution for the Newstates of America (March 1984 CRC bulletin).

A Newstates Constitution exists! Funded by the Rockefeller Foundation and produced by the Center for the Study of Democratic Institutions, Santa Barbara, California, it awaits implementation by a captured Congress.

A constitutional convention would provide the appearance of legality and opportunity for eliminating the Constitution, now a bar to one world government sponsors.

Ill-considered state memorials alleging balanced budget purposes polarize public frustration and channel political momentum toward a catastrophic conclusion.

Challenging civil and private revolutionaries, Ellison and Kurowski explain what dedicated citizens in sister states may do to derail the rush toward a constitutional convention.

The argument for reconsideration, based on constitutional authority, is set out in their handbook, "A Second Constitutional Convention—Will it Happen?", extracts reprinted below, and PETITION BEFORE THE MARYLAND GENERAL ASSEMBLY, reproduced in full.*

A SECOND CONSTITUTIONAL CONVENTION

Only two State's Legislatures approval is now needed to demand that a Constitutional Convention take place for the illusory purpose of *"balancing the federal budget."* This puts our Nation at a crossroad which will separate true patriotic Americans who have read their Constitution and are aware it already commands the federal budget is required to be balanced from those who have not read the Constitution and fail to recognize the Constitution clearly mandates that Congress shall balance its budget.

Surely, the call for a Constitutional Convention is not a liberal or conservative issue, nor is it exclusively being promoted by democrats or republicans. It is, however, a very serious matter in which the *truth ought to be spoken and made available to the general public at all costs.* Why? Because the freedoms which American Citizens now enjoy, and have foolishly taken for granted for so many years, may very well be unjustly compromised if a constitutional convention should take place. On the other hand, if Congress is now immediately compelled to obey the Constitution, requiring sound fiscal policies, a constitutional convention may be forced which could jeopardize our most sacred freedoms.

To understand the real threat of allowing a constitutional convention to take place, it is important to recall what almost took place in New York in 1967. During the mid-1960's, a constitutional convention was called to amend New York's Supreme law. At the time, a small group believing the government's power of taxation ought to be used to aid religious schools, was successful in pressuring delegates to the convention to adopt no constitutional prohibitions against such aid. Fortunately, in view of the threat that government aid eventually leads to dependency upon government, which in turn allows the government's power of the purse to be used to impose regulations and controls over those who become financially addicted, the citizens of New York had the final say by popular vote, which is required to amend New York's Constitution.

After the vote was counted to approve or disapprove what the delegates to the convention thought best for the People, the People of New York disagreed with their delegates by over 72 per cent! The financial independence of religious schools was thus saved from possible government take-over through the power

*Permission, Edward A. Ellison, Jr., and John William Kurowski, 9104 Edmonston Court, #301, Greenbelt, MD

SECOND CONSTITUTIONAL CONVENTION (cont.)

the purse. But, only because the People had the final say by their popular vote on any changes to be made to their State Constitution.

Following a constitutional convention, in which the United States Constitution and its Bill of Rights could have been totally rewritten and destroyed, the ratification process does not permit the People to have the final say through a popular vote. Although the People may disagree with their State Delegates and Legislators by a 72 per cent margin—as they did in New York—a popular vote in each of the States is not necessary for the States to ratify what State Legislatures may think are appropriate or expedient changes to be made to the Constitution of the United States.

There are two ways by which to amend the Constitution of the United States, as stated in Article V of the United States Constitution:

ARTICLE V.

The Congress, whenever two-thirds of both Houses shall deem it necessary, shall propose Amendments to this Constitution, or, on the Application of the Legislatures of two-thirds of the several States, shall call a Convention for proposing Amendments, which in either Case, shall be valid to all Intents and Purposes, as part of this Constitution, when ratified by the Legislatures of three-fourths of the several States, or by Conventions in three-fourths thereof, as the one or the other Mode of Ratification may be proposed by the Congress; Provided that no Amendment which may be made prior to the Year One thousand eight hundred and eight shall in any Manner affect the first and fourth Clauses in the Ninth Section of the first Article, and that no State, without its consent, shall be deprived of its equal Suffrage in the Senate.

Simply put, the Constitution can be amended in one of two ways: the first is by a proposed amendment(s) being offered to the States by Congress, which are limited to one specific issue, and if ratified by three-fourths of the States becomes law. The other is by a Constitutional Convention being demanded by two-thirds of the State Legislatures, in which case the entire Constitution and its Bill of Rights could wind up being rewritten, and if approved by three-fourths of the States becomes law.

Herein lies the dividing line between those who want the Constitution followed, and also want a balanced budget, from those who would allow our Republic's most precious document to be tinkered with by State politicians, before establishing the truth. The question is: Will truth prevail, or will truth be ignored allowing 38 State Legislatures to do as they please?

In support of the truth, a review of the debates held in Convention during the framing of our Constitution—specifically those which eventually produced Article 1, Section 2, clause 3, and Article 1, Section 9, clause 4—are essential reading for all who believe a constitutional convention is necessary to *"balance the federal budget."* The fact is, *the Constitution already commands the budget to be balanced!* Not only is this true, but, the balanced budget clause of our Constitution, Article 1, Section 2, clause 3, has been imposed a number of times in our Nation's history (see appendix A) (deleted), and is today being ignored by the very leaders who are

The balanced budget clause of our Constitution reads in part:

"Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union . . ."

This article of supreme law vests Congress with an emergency power demanding a direct tax to be laid upon the State Governments, (in proportion to each State's voting strength in Congress) if the constitutionally authorized expenditures of Congress exceed the revenue raised from impost and excise (indirect) taxes.

In disobedience of this Constitutional Command, Congress now borrows to finance its deficits, then taxes to pay the interest on borrowed money, instead of taxing the State Governments to finance said deficits which would immediately end accumulated deficits, and save American Citizens billions of dollars per month interest payments which they now pay on borrowed money.

Although it is true that Congress has been granted power to borrow money, the exception to, and the Constitutional restriction placed upon this borrowing power, is that *Congress may not borrow to finance a deficit!*

On an annual basis, a deficit may be described as the amount of money Congress spends, and/or borrows, during a fiscal year in excess of the amount of money brought in from indirect taxes (imposts and excises) during that year. This fiscal year, Congress has managed to borrow and spend approximately $180 Billion more than it has brought in. To finance this deficit, Congress will simply borrow money which will eventually be taxed away from the American People. Having borrowed this money, the American People will now be taxed, in addition to the $180 Billion, over $11 Billion per month to pay interest on the money borrowed by Congress. This action of Congress increases the public burden of taxation in violation of the balanced budget clause of the United States Constitution!

In effect, the American People are now being taxed, in violation of the Constitution, over $130 Billion per year to pay interest on borrowed money, and pay these Billions of dollars before one dime of collected tax revenue is used to provide for our Nation's common defense or promote our general welfare. Why? Because Congress ignores the intent of our Constitution, and those who call for a balanced budget, they fail to realize a balanced budget clause already exists in our Constitution, waiting to be enforced, which would instantly cure Congress' current irresponsible, reckless and criminal fiscal policies.

During the Constitutional Convention of 1787, a thorough reading of the debates which took place in Convention, clearly shows that Article 1, Section 2, clause 3 (the balanced budget clause), was specifically adopted to insure fiscal responsibility and honesty from a Congress about to be given life. Equally true is the fact that the State Ratifications, signed by the original thirteen States of our Union, echo this point quite clearly. For example:

STATE OF MASSACHUSETTS

In Convention of the delegates of the People of the Commonwealth of Massachusetts February 5th 1788

but when the Monies arising from the Impost & Excise are insufficient for the publick exigencies nor then until Congress shall have first made a requisition upon the States to assess levy & pay their respective proportions of such Requisition agreeably to the Census fixed in the said Constitution; in such way & manner as the Legislature of the States shall think best, & in such case if any State shall neglect or refuse to pay its proportion pursuant to such requisition then Congress may assess & levy such State's proportion together with interest thereon at the rate of Six per cent per annum from the time of payment prescribed in such requisition

This same language is also found in several other Resolutions signed by the original thirteen States by whom the Constitution of the United States was ratified. (See Appendix B for South Carolina and New Hampshire Ratifications.) (deleted)

Congress is in fact commanded to lay a direct tax upon the State Governments (the State Rate Tax) if "... *Monies arising from the Impost & Excises are insufficient for the publick exigencies ...*"

If followed today, not only would Congress be compelled to end each fiscal year with a balanced budget, but, irresponsible spending and inequitable taxation by Congress would instantly be ended! Why then, call for a constitutional convention to balance the budget, when the Constitution already contains the provision? Is there a better plan being offered by those who call for a convention? Is there a defect in our Founding Father's solution, or mischief in the air?

Contrary to the belief that fiscal restraint was not addressed by the Framers of our Constitution, the foregoing facts cannot be changed to what they are not. A balanced budget provision already exists which will render Congress fiscally responsible if and when the People demand it be followed.

The real problem, if one exists, is that we have dishonest legislators, conservatives and liberals, republicans and democrats, masquerading as fiscal conservatives who disobey the intent of our Constitution; have conned American Patriots around the country into believing a Constitutional Convention will restore fiscal responsibility in Congress Assembled; and have requested financial contributions be made for such a cause. But some, as we should like to believe, are simply misinformed, and are now beginning to withdraw their support for a Constitutional Convention in favor of the truth!

It is a fundamental principle of constitutional law, that legislative intent must be established when determining what the Constitution means. To follow the Constitution, is to carry out the intentions of the authors of, or parties to the written instrument... these intentions are found in the debates during which time the Constitution was framed, and were recorded by James Madison and others.

In the instant case, the delegates of the States sent to the Convention of 1787 (the Authors of our Constitution), and, the parties to the Constitution, (the States), clearly intended, as exhibited in the delegates' debates during the convention, and also the ratification documents signed by the States, that if the expenses of Congress should not be met by the revenue raised from imposts and excise taxes (indirect taxes) that Article I, Section 2, clause 3, (the State Rate Tax) would be [illegible]

now being disobeyed by a rebellious Congress, which now engages in unconstitutional and criminal borrowing practices; practices which have become so evil in nature that the very existence of the United States, and our general welfare, is now threatened by a nationwide financial collapse.

The emergency taxing power contained in Article I, Section 2, clause 3, of the United States Constitution, was granted to Congress for a number of reasons; to extinguish the debt of the Revolutionary War; to preclude Congress from accumulating year-end deficits through borrowing; to insure Congress had adequate taxing authority in the event an emergency should arise whereby indirect taxation might be found insufficient to meet such an emergency. But, equally important, this article of Supreme Law was meant to prevent a factious majority in Congress from destroying our Republic financially, by using its voting strength to increase the tax burden upon those whom they could outvote, without also increasing their own burden of taxation in a similar fashion. *(See Pollock v. Farmers' Loan and Trust, 158 U.S. 601; 1894)*

The very practices forbidden by our Constitution are now joyfully engaged in by a criminal element in Congress, and are the roots from which todays irresponsible spending, inequitable taxation, uncontrollable borrowing, and year end accumulated deficits have grown. Every evil associated with democracies of the past, which has led to their predictable financial destruction, is now commonly practiced by our public trustees in violation of the Constitution they have sworn to uphold, and which governs our Constitutional *Republic*.

The leading evil associated with democracy (mob rule government) is that the rights of an individual or minority cannot be protected against the omnipotent majority, and that as soon as the people learn they can use the political system to vote and tax away the property of their neighbor, they do so. Consequently, the societies' productive base is then slowly eaten away until there is no productive base left. Generally, as history proves, it is at this point when economic conditions are at their worst, that the mass of the people will submit themselves to any form of government which promises relief from their sufferings. Our Nation is now sitting on that borderline. Will we be so foolish to allow a Constitutional Convention to take place when our Constitution already demands Congress is to balance its budget?

In conclusion: From 1787 to the present, there's been no need to call for a constitutional convention. Twenty-six amendments are evidence of this fact. If the true purpose of the leaders who are pushing for a constitutional convention is indeed a limited one, and confined to "balancing the federal budget", then why not simply demand the existing balanced budget clause of the United States Constitution be enforced? Ought not such an attempt first be made before proceeding into the uncertain areas of a full blown constitutional convention, and flirting with the dangers involved therein?

The Framers of our Constitution indicated in the notes on the debates as recorded by Madison, that their conduct, from the time of abandoning the purpose of amending the Articles of Confederation, to writing a new constitution, was criminal and exceeded any authority with which they had been commissioned. Thereupon their first act was an agreement that all [illegible]

be kept absolutely secret. Is there any doubt this practice would not be repeated if a constitutional convention is convened now?

* * * * * * * * * * * * * * * * *

America could not participate in a world government and retain the protection or guarantees of our Constitution because such a constitution would be in conflict with any set of rules used in the governing of all nations under one controlling oligarchy. Freedom as enjoyed by Americans is not enjoyed to such degree any where else in the world, and such freedom would be a contradiction under a global government controlled by power brokers and/or international bankers. America is threatened by the greater clear and present danger of a Constitutional Convention than was ever posed by her exposure in World War I, II, the Korean or Vietnam conflicts. The arousal of the people to demand obedience to the Constitution by Congress, the Executive and the Judiciary, is the only method for the saving of America to perpetuate for Americans the liberty and freedom upon which this Nation was founded.

DEFEND AND PRESERVE THE CONSTITUTION!

Adapt Maryland Petition to rescind/prohibit participation by your State in constitutional convention to balance Federal budget.

PETITION

Before the Maryland General Assembly

Annapolis, Maryland

1984

We, the people of Maryland, hereby petition our State Legislature to adopt Resolutions as affixed hereto, by which the State of Maryland:

1. Will rescind Maryland's existing call for, and/or participation in, a Constitutional Convention to balance the federal budget;

2. Will demand the United States in Congress Assembled in order to balance the federal budget to immediately comply with, and utilize, the emergency taxing power authorized by Article 1, Section 2, Clause 3 of the existing federal Constitution; said Article of Supreme Law having already been debated at great length during the Constitutional Convention of 1787, and agreed by the States to be the equitable and least corruptible method by which to effectuate a balanced federal budget!

PROPOSED RESOLUTIONS

RESOLUTIONS ADOPTED

1984

by

The General Assembly of Maryland

for the purpose of:

I Rescinding Maryland's call for and/or participation in a Constitutional Convention to balance the federal budget;

II Demanding that Congress Assembled comply with and utilize the emergency taxing power of Article 1, Section 2, Clause 3 of the United States Constitution to immediately effectuate an annually balanced federal budget!

WHEREAS, the Congress of the United States is in rebellion against the Constitution of the United States;

WHEREAS, the Congress of the United States Assembled has failed to conform to the fiscal restraints of the Constitution of the United States;

WHEREAS, the Constitution of the United States commands that when monies raised by federally imposed Duties, Imposts and Excises are insufficient to meet the public exigencies, a Direct tax must be laid by Congress, apportioned among the States, as prescribed by Article 1, Section 2, Clause 3, to extinguish the deficit, and thereby "balance the annual federal budget;"

WHEREAS, the Congress of the United States Assembled has accumulated unfunded debt liabilities which now exceed eight (8) trillion dollars;

WHEREAS, the Congress of the United States Assembled has in violation of the federal Constitution practiced the borrowing of debt contrary to the grant of power to borrow money upon the pledge of public credit;

WHEREAS, the Congress Assembled has unlawfully burdened our Nation's succeeding generations with needless interest payments on debt, now at a yearly rate in excess of 120 Billions of dollars per year;

WHEREAS, Congress Assembled has made no provision to extinguish the principle of said debt;

WHEREAS, Congress Assembled now spends 120 Billions of dollars per year from collected tax revenue to pay interest payments before collected tax revenue is used to provide for our Nation's common defense or the general welfare of the United States;

WHEREAS, such circumstances now threaten to destroy the very existence of Maryland's economic enterprises, and the economic freedom of her citizens;

RESOLVED, that the State of Maryland hereby rescind Her call for a Constitutional Convention, and/or participation in a Constitutional Convention to "balance the annual federal budget."

RESOLVED, that the State of Maryland demands that the Congress of the United States Assembled follow Article 1, Section 2, Clause 3 of the United States Constitution to extinguish any annual deficit which would arise when revenues of Duties, Imposts, and Excises collected under the grant of taxing power contained in Article 1, Section 8, Clause 1 are insufficient to meet the public exigencies (those Constitutionally authorized objectives) thereby balancing the annual federal budget;

RESOLVED, that if Congress Assembled fail to obey the Constitution so as to balance the annual federal budget, that the State of Maryland, by the direction of Her Governor, through the office of Her Attorney General, will charge the Congress as being in rebellion and of treasonous conduct;

RESOLVED, that the State of Maryland recall her representatives and replace them with others who will uphold their oath of office to support and obey the Constitution, bringing suit against Her former representatives in their personal capacity under Article 1, Section 6, for their treasonous conduct;

RESOLVED, that the Legislature of Maryland have adopted these Resolutions to rescind Maryland's call for, and/or participation in, a Constitutional Convention so that the peace, dignity and Government of the State of Maryland may be preserved.

PROSPERITY RESTORED BY THE STATE RATE TAX

Unlike any of the political party gimmicks and schemes currently being offered by career politicians, the State Rate Tax is part of a plan to remedy outright dishonesty, now practiced by the Congress of the United States. As you will see, this plan is not simply another tax proposal, nor a political party creation to maintain the current status quo. It is a revolutionary concept to introduce checks and balances linked to taxation, which will terminate reckless spending by Congress; arrest year end deficits accumulated by Congress; and, preclude inequitable taxation which has been institutionalized by political party loyalists.

Under this plan, the control of Congress is in part achieved by immediately requiring all federal expenditures to be met by *indirect taxation*, imposts, duties and excises. Imposts are taxes imposed on imported goods or merchandise; duties are custom charges levied on things brought into the country; excise taxes are inland impositions upon articles of consumption (alcholic beverages, cigarettes, gasoline, etc.) manufactured for sale or consumption within the country. Excise taxes may also be imposed on *illegally earned income (gains or profits); upon income earned under licenses granted by government, or upon income earned through a specific privilege which government has been delegated power to authorise.*

The theory behind funding government functions from taxes laid upon articles of consumption, is that citizens are to be free to contribute to government in the manner and frequency by which they spend their money.

Taxes on articles of consumption, it must be noted, contain their own check and balance against political corruption, and are the least oppressive of all taxation. A tax on articles of consumption, says Hamilton, number 21, Federalist:

> " . . . may be compared to a fluid, which will in time find its level with the means of paying them. The amount to be contributed by each citizen will in a degree be at his own option, and can be regulated by an attention to his resources. The rich may be extravagant, the poor can be frugal; and private oppression may always be avoided by a judicious selection of objects proper for such impositions. (I)t is a Signal advantage of taxes on articles of consumption that they contain in their own nature a security against excess. They prescribe their own limit, which can not be exceeded without defeating the end proposed__that is, an extension of the revenue."

If any particular article of consumption is excessively taxed, it would reduce the volume of its sales and the raising of revenue would be eluded. This *check and balance* will determine the limit to which each selected article may be taxed. By forcing Congress to select *specific articles of consumption*, as opposed to a *blanket national sales tax*, a system of taxation is achieved in which the general public may actively participate in the selection of the specific articles to be taxed, and, to what degree they will be taxed.

If, for example, Congress laid a twenty dollar per pound tax on all imported caviar sold in the United States, (an excessive tax even for a luxury article) the wealthy, and merchants dealing in this product would undoubtably cry "foul" and withdraw their political support from those representatives responsible for the imposition of an excessive tax on caviar. If, however, the tax were moderated to a tolerable level, the purchaser's resistance would also diminish and revenue would be generated!

Another important advantage to labor and industry, when revenue is raised by taxes on *specific* articles of consumption, is that the necessities of labor (food, shelter, clothing, etc.) tools of production, and supplies necessary to conduct business may be excluded from

the tax list. This will allow industry and business to flourish unimpeded by taxation; employment to expand, and the welfare of our States' commerce to be actively protected from oppressive taxation.

Under the proposed State Rate Tax plan, the expenses of the federal government—those specifically authorized by the Constitution of the United States, which are clearly enumerated and subjoined to Article 1, Section 8, Clauses two through eighteen—are to be funded by indirect taxation! If the annual expenditures for these Constitutionally authorized functions of Congress exceed the revenue raised from imposts, duties and excises, then, and *only then*, shall Congress be required to impose the State Rate Tax in order to preclude Congress from adding a year end deficit to the national debt.

The State Rate Tax is a direct tax required to be imposed if an annual deficit occurs. This tax is to raise a sum certain (annual deficit), and each states' share is to be calculated upon its number of representatives (votes) in Congress. The tax is to be used only if imposts, duties and excises fail to meet Congress' annual expenditures.

Upon imposition of the State Rate Tax, the Secretary of the United States Treasury, to extinguish an annual deficit, would submit a bill to each states' capitol for its apportioned share of this deficit. Each state would be left free to raise its apportioned share within a time specified by Congress. In the event there is a surplus of money in the United States Treasury at the close of a fiscal year (i.e. there is no deficit), this surplus would be applied to a *sinking fund* to reduce or extinguish the national debt. If there is no deficit, nor a national debt, any surpluses raised from impost duties and excise taxes may be returned to the states by the rule of apportionment.

FORMULA FOR COMPUTING EACH STATES' APPORTIONED SHARE OF DIRECT TAX

$$\frac{\text{States' No. of Representatives (votes) in House of Representatives}}{\text{total number of Representatives in House of Representatives}} \times \text{amount needed, not fundable by federal indirect taxes (imposts, duties, excises)} = \text{States' share of S.R.T.}$$

MATHEMATICAL COMPUTATION FOR THE STATE OF MARYLAND FOR A $ 100,000,000 DIRECT TAX APPORTIONED AMONG THE STATES (STATE RATE TAX)

$$\frac{\text{Md's No. of votes in House of Reps.}}{\text{total No. of Reps. in House of Reps}} \quad \frac{8}{435} = 1.839 \times \$\ 100,000,000. = \$\ 1,839,000.$$ Maryland's share apportioned tax

The following chart shows the current rate of apportionment for a few States. This chart demonstrates each States' obligation under the State Rate tax, or, the returnable amount due to the State if federal indirect taxes have exceeded the annual expenditures of Congress. The chart is based upon a $100,000,000. returnable surplus, or the same sum certain to be laid as an apportioned direct tax:

STATE	NUMBER OF REPRESENTATIVES (votes in Congress Assembled)	APPORTIONMENT RATE OF TAX OR AMOUNT TO BE REFUNDED
Alabama	7	1.609 % = $ 1,609,000.
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New York	39	8.965 % = $ 8,965,000.
West Virginia	4	.919 % = $ 919,000.

NOTE: Under the rule of apportionment, Washington, D.C. not being a State, and not having a vote in Congress, is not subject to the State Rate Tax.

ATE RATE TAX ENDS FISCAL IRRESPONSIBILITY

Among the many benefits offered by the State Rate
x is its ability to control Congress' current reckless
scal policies. If Congress remains fiscally irrespons-
le and attempts to use its *limited power of taxation* to
benevolent at home or abroad, or finance ventures that
e not *Constitutionally authorized*, or ignores the com-
nd that annual deficits are to be cancelled at the close
each fiscal year, the consequences of such actions will
mediately pose a political threat to each states' current
ministration. In the former case, if Congress continues
exceed its constitutionally authorized objectives, re-
rring the imposition of the State Rate Tax to extinguish
eficit so created, the financial strain on the state
easuries will become so overtaxed that a politically
esirable burden will be repeatedly thrust upon the
sting state legislatures, causing them to increase state
xes to fund Congress' unlawful expenditures. In the
tter case, if Congress should ignore the command that an
nual deficit is to be cancelled at the close of the fis-
l year, and votes to borrow to fund this deficit, the
cumulated deficits will rapidly mount and hang over the
ads of each states' legislators like an axe, ready to be
portioned at any time and deplete the State Treasury.

In either case, if a states' Congressional Delegation
cides to follow reckless fiscal policies while in Wash-
gton, D.C., the consequences of such policies will place
threatening political liability upon the Governor of that
ate and its Legislators, forcing them to bear the burden
increasing state taxes, or, they may promote their own
olitical future by demanding a recall of their States'
ckless spenders. This check and balance will stimulate
e Governers of each state and their Legislators, to keep
jealous eye on the spending policies of their represent-
tives sent to Washington, D.C., and will act as a safe-
ard to insure that a states' Congressional Delegation
ll vote the financial limitation which its own state can
ar.

TAKING STOCK IN AMERICA

One of the most damaging things to America's labor, small businesses and manufactures, is Congress' reckless policy of borrowing money which needlessly and destructively increases our national debt by billions of dollars each week!

Instead of America's monied interest being asked by Congress to take stock in America by investing in the modernization of her small businesses and manufacturers, so they may once again compete with foreign competitors, provide employment for Americans and restore America's strength and ability to produce her own articles of consumption all of which makes for a healthy nation Congress through the Department of the Treasury, auctions off billions of dollars in interest bearing government securities each week, to a special monied class cartell. Among this monied class special interest group are foreign financiers who rush to purchase United States Securities, while Americas' labor, small businesses and manufactures will not only be taxed to pay back this borrowed money, but the interest thereon which now amounts to over 11 billion dollars per month!

The sad truth is, Congress is using its power of taxation and borrowing in a perverted fashion, not to provide for America's common defense or promote its general welfare, but rather, Congress is using its powers to bleed America's small businessman, and laboring class citizen, to pay financial dividends to an affluant class who invest in government securities, and use their interest profit to modernize the industrial enterprises of communistic nations such as Red China, where slave labor exists. Why is it that patriotic Americans, after taxation, have not a dime left with which to take stock in America and modernize her industrial enterprises? Who was it that stated "If treason be profitable, let none dare call it treason?"

Because Congress has been left unchecked, and allowed

to engage in unmonitored spending and borrowing sprees, Americas' labor and industry is now paying over $130 billion per year in needless interest payments on borrowed money, and pay this interest *before one dime of collected revenue is used to provide for our nations' common defense or promote the general welfare of the United States.*

This irresponsible borrowing by Congress has placed the United States in an extremely hazardous situation, while it has happily increased the profits of international bankers and financiers to the tune of over $11 billion per month!

The enormous interest payments now paid by American Citizens, because of Congress' politically expedient lust for borrowing, causes the private sectors' investment capital to dry up, interest rates to skyrocket and investment credit for business and industry to become unaffordable. This never-ending-borrowing by Congress has impaired the growth of Americas' small businesses, has helped to create unemployment in almost every state, and has forced a number of our states' largest industries to either flee our country or go bankrupt.

Under the State Rate Tax plan, the accumulation of federal deficits and reckless borrowing to fund these deficits will become a nightmare of the past, and Congress will no longer be free to engage in borrowing policies detrimental to the States need to expand and modernize their industrial enterprises.

STATE RATE TAX SAVES AMERICAN CITIZENS BILLIONS

The annual cost of maintaining a federal income tax collection agency (IRS) whose budget is about $3 billion, would be almost totally abolished, and the annual cost to the nation, both in time and resources, to record confidential financial transactions of our nations' entire population, *under a pretext of raising revenue,* would also be ended by the State Rate Tax.

POLITICAL DISUNITY IN AMERICA REDUCED

The State Rate Tax, because it is a tax imposed u the state governments by a *fixed formula, and not upon people or their property,* will abolish the present syst of federal income taxation and all the dishonorable ta sheltering gimmicks and lobbying of Congress to create special interest tax legislation. Special interest ta legislation has caused a dangerous rise in political factions throughout America, and has led our nation to become politically disunited. By establishing a *fixed rule for direct taxation,* there is no allowance for pol ical disunity to be bred through the creation of tax loopholes and special interest tax sheltering gimmicks created by Congress. This will help to bring the Stat closer together to solve Americas' real social and eco nomic problems, and reduce political disunity bred amo the people by Congress.

RELIGIOUS LIBERTY PRESERVED BY STATE RATE TAX

In view of the alarming development recently occu ing in our nation, by which the power of taxation has been blatantly used to *control and regulate into extinction a number of small fundamentalist churches an their schools,* the State Rate Tax will come as a bles ing to our nations' religious community; *it will preserve their religious freedom guaranteed by the First Amendment of our Constitution, and shield the Amendmen from being weakened under the cloak of raising revenu*

STATE LEGISLATURES BEST JUDGES IN RAISING DIRECT TAX

There is no question as to a states' legislature being the best judge as to the mode of raising a federally imposed direct tax. The State Legislature being closer to the people, is better informed to disbu such a burden in an equitable manner, taking into acc unique geographical and economic circumstances, and m

ing taxation accordingly. The State Rate Tax allows each State to be its own judge in deciding how its share of this federal burden shall be raised, and will protect all people, rich and poor alike, from the costs of the federal government being raised and collected by Congress in an unjust, arbitrary manner; it puts the control of such an important and personal matter into the hands of the peoples local representatives who must meet this obligation.

Under this plan a balance is achieved in which equitable taxation will be the final result. If a state government should impose inequitable taxation, even if it is only resorted to when raising a states' share of the apportioned direct tax imposed by Congress, and the state government insists on distributing its burden selectively upon the States' productive citizens or its small businesses at rates which become intolerable, these citizens, or small businesses, are able to flee from such taxation to states whose administrations respect the productive members of society, and which offer equitable systems of raising revenue.

The freedom of a states' business community to flee oppressive taxation is an important check and balance to prevent the power of taxation being used to destroy. As it is now practiced, productive citizens have no where to flee to escape federal taxation, and so, Congress is left to engage in mischief and manipulate taxation so as to seek out hard working wage earners, or small businesses, asking them to pay a disproportionate burden of federal expenditures, regardless of where they may live.

OPPOSITION TO THE STATE RATE TAX

Those in opposition to the State Rate Tax claim the system would place an unfair tax burden upon those states having the greatest voting strength in Congress. The fact is, the State Rate Tax *is not to be imposed except upon dire emergency as previously outlined, and indirect taxes are to be Congress' primary source of revenue.* However, the states having the larger voting

strength in Congress, and required to pay a proportionat share of this direct tax based upon their larger voting strength, will also have a greater say in the policies Congress adopts, and a larger population to absorb their burden if the State Rate Tax is imposed.

By matching each states' share of the direct tax to its voting strength, no state can use its voting strengt to increase the burden of taxation upon other states wit out also increasing its own burden of taxation in a simi lar fashion! Thus, the voting strength of each state ca in no way be used as an economic advantage when the Sta Rate Tax is invoked; each state pays according to its voting strength as required by Article 1, Section 2, Clause 3; Article 1, Section 9, Clause 4 of the United State Constitution, and *this was the intention of our Founding Fathers.*

IN CONCLUSION

Congress has never been granted a blanket power or unlimited power to tax the people. Congress has no pow to directly tax one, for the benefit of another, a viol tion of voluntary association; nor a power to be benevo at home or abroad at the expense of the American citize through a tax on his money or other property. Congress may not tax to spend as it pleases, for whatever whim i may entertain. Our Founding Fathers gave us a free cou and meant for us to remain free, and gave us the tools which to keep us free. The tools of the Constitution a the checks and balances it provides are to protect the sovereignty of the Citizen.

There has never been a grant of power from the peo to the Congress to tax the people of the United States. State Rate Tax is the Constitutionally provided limited power of direct taxation permitted to Congress by the of the people. And, we will continue to suffer as a na until we demand our Constitution be followed.

Art. 1, Sec. 2, Cl. 3 & Art. 1, Sec. 9 Cl. 4

DIRECT TAXES

Involuntary—cannot be avoided
Subject to/Rule of Apportionment according to Congressional Representation.
Tax bill sent to each State.
Maryland's share = 1.83% of sum certain.
To be used in emergency only; to prevent deficit spending.
To reduce a war debt.
No power to tax the people of the United States.

Art. 1, Sec. 8, Cl. 1

INDIRECT TAXES

Voluntary—can be avoided
Subject to/Rule of uniformity; geographic uniformity only is required.

(PRIVILEGES)				(EXCISES)
Corporate Charter	License to practice Law	Customs Duties	Illegal profits or gains.	Mfr. sale use tax on articles of consumption.

All of the above categories demonstrate that the subjects, objects, or items of taxation are inanimate objects and therefore there is no grant of power or authority to the Congress of the United States to tax the people of the United States.

Since the Constitution of the United States provides for only two classes of taxation, Direct and Indirect, with direct taxes to be laid only upon the States and indirect taxes to be laid only upon inanimate objects it is proven that the Congress has not been given any Constitutional authority to tax the people of the United States.

The restrictions upon the taxing authority of the Congress do not prohibit any individual from volunteering to become a taxpayer and to make oneself subject to the authority of the IRS by the filing of a 1040 form. The filing of a 1040 makes you subject to the authority of the IRS even though you may not owe any money to the government following their formula to determine the existence of any profit or gain. (Have a tax liability.)

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12-[illegible] March 26, 1984

22 March
Congratulations! Excellent article.
Lou

Balanced Budget In Constitution

(Continued from the Spotlight)

By Trisha Katson

The U.S. Constitution mandates that the budget be balanced. Thus, the Constitution does not need to be amended to provide a balanced budget.

With a federal deficit of about $200 billion expected again this year, the national debt mounting and a Congress unwilling to change its free-spending ways, numerous remedies have been proposed.

These include various Constitutional amendments to balance the budget and an array of inventive ways to increase your taxes. For good measure, various ways to cut spending have even been offered.

But in the quest for a new solution to the serious economic problems that now relegate a bankrupt United States to debtor nation status, few have bothered to turn to our existing Constitution.

REVOLUTIONARY FORMULA

Our Founding Fathers had designed a revolutionary and equitable concept of taxation that when implemented furnished perfect checks and balances between the federal and state governments and discouraged deficit spending by Congress.

If this Constitutional formula had been observed as our forefathers intended, our nation would not be encumbered with a national debt of $12 trillion (counting unfunded liability) and the fiscal nightmare we now suffer.

If you are not familiar with the method our forefathers designed to balance the budget and assure prosperity, you are not alone. The vast majority of lawyers, tax attorneys, accountants, and even those who envision themselves as "Constitutional scholars," are unacquainted with this formula because it is not taught in public schools, colleges or even law schools.

Fortunately for all patriotic Americans who are seeking the answer to reform the fiscal policies of our government, two dedicated populists have discovered it.

Edward A. Ellison Jr. and John William Kurowski spend a great deal of their time educating Americans about this Constitutional formula to balance the budget. They eschew accolades for themselves and are quick to point out that the message they seek to deliver to the people is not their own but that of our forefathers. Kurowski describes himself and his colleague simply as "ordinary citizens, just trying to restore our republican form of government."

See special offer on page 6.

To this end, they travel around the country, making appearances on TV and radio talk shows; they speak at public gatherings and contact any parties they believe should take an interest in the achievement of a balanced federal budget.

GIMMICK

Mindful of the attitude on the part of some people that the Constitution is an "antiquated" document, Ellison and Kurowski use a gimmick of sorts to promote the forefathers' formula. They call the proposal the "state rate tax" (SPOTLIGHT, Dec. 12, 1983) and initially present it as if it were a new idea. After they have explained the concept to interested parties, they then explain that this is no new solution, that it comes right out of the Constitution, and that they are only expounding on the formula invented by our Founding Fathers.

Here is the formula now embodied in the Constitution (which the president, Congress, state legislators, and all federal and state executive and judicial officers are bound by oath to uphold):

Congress has been granted the Constitutional authority to apply taxation in two basic forms:

- Direct taxes, which are involuntary. These are subject to the rule of apportionment according to congressional representation (Art. 1, Secs. 2 and 9 of the Constitution).
- Indirect taxes, which are voluntary. These are subject to the rule of geographic uniformity (Art. 1, Sec. 8).

Direct taxes are raised by state legislatures, which take their own unique geographical and economic circumstances into account when deciding on the manner in which to impose them. These taxes are to be used only in emergencies or to prevent deficit spending or to reduce a war debt.

Indirect taxes are raised by the federal government in the form of excises placed on articles of consumption; on income earned under government-granted licenses; and on income earned through a specific privilege which government has been delegated power to authorize.

Indirect taxes are also provided by imposts and duties.

NO TAX ON PEOPLE

As neither indirect nor direct taxes are placed on people but on inanimate objects or on privileges granted to individuals by the government, it is clear that Congress has never been given any Constitutional authority to tax the people of the United States.

With the state rate tax, the federal government first collects the revenues it needs to pay for its outlays through indirect taxation. Article 1, Section 8 lists authorized objectives of the federal government to be met through indirect taxation. If the federal government does not recover adequate revenues through indirect taxation, then each state is sent a bill for the remaining amount, according to the representation the state has in the House of Representatives.

John Kurowski (left) and Ed Ellison, who live and work in Maryland, have been studying the Constitution and the intent of our Founding Fathers for the last five and 10 years, respectively. They are engaged in a grass-roots drive to tell the people about how the state rate tax—our forefathers' formula, as outlined in the Constitution—will balance the budget.

Congress would not engage in deficit spending and borrow with interest from the Federal Reserve to cover the difference, as is today's practice.

California, with 45 representatives in the House, would pay 45 times as much as Delaware, which has only one representative.

If the federal government had collected more revenues through indirect taxation than it needed to pay for its outlays within a fiscal year (it seems unlikely now, but this has happened in our history), this would result in a surplus, which would be refunded to each state according to its representation.

Since it is unlikely that many states would relish being forced to pick up the tab for whatever spending the central government is unable to pay for, Congress is going to exercise fiscal restraints it never thought it had.

Congress would be less likely to authorize giveaways to foreign countries; bail out the international bankers; subsidize failing industries; provide handouts to able-bodied yet non-producing members of society; or pander to every special interest group imaginable.

CANCEL DEBTS

If Congress continued its present practice and disobeyed the Constitutional command that all debts be extinguished each fiscal year, then the state legislatures, knowing that these debts could be apportioned among themselves at any time, would keep the pressure on Congress to cancel these debts.

If state legislators allowed Congress's spending to go unchecked, an unlimited amount of direct taxes might then have to be paid by their constituents and these state legislators would soon find themselves without jobs.

As Kurowski notes: "The people are closer to their state legislators than they are to their congressional delegation. It's a longer walk from, say, California to Washington for angry constituents armed with tar and feathers than it is to their state capital."

This is the "state rate tax" and it is the ideal solution to stop deficit spending by Congress.

The proposals before Congress and endorsed by the administration to provide for a Constitutional amendment to balance the budget are fraudulent but politically expedient devices employed in this election year (SPOTLIGHT, March 19).

The balanced budget/tax limitation amendments receiving the most support among congressmen do not make a balanced budget mandatory. These bills allow the federal government to keep borrowing from the bankers. They provide no method to repay our national debt and do not limit the rate of tax increases.

PROSPERITY

In their booklet "Prosperity Restored by the State Rate Tax," Ellison and Kurowski note: "Our Founding Fathers gave us a free country and meant for us to remain free and gave us the tools with which to keep us free. The tools of the Constitution and the checks and balances it provides are to protect the sovereignty of the citizen."

Our forefathers' formula has not been followed in many years. The last time it was used was in 1861.

It is up to concerned citizens to educate their neighbors and their state legislators about the state rate tax and to demand that their congressmen obey the commands of the Constitution, which they are sworn to uphold.

For more about the state rate tax, contact: Free State Constitutionists, 6509 York Road, Baltimore, Maryland 21229.

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REPLY TO ST. LOUIS

August 30, 1984

Roderick A. DeArment
Chief Counsel
Committee on Finance, Rm. SD-219
Dirksen Senate Office Bldg
Washington, D.C. 20510

Re: Written Statement for Tax Reform Hearing, Sept. 17th.

Dear Mr. DeArment:

Please find enclosed for submission to the record of the hearing to be held on September 17, 1984 addressing fundamental tax reform a brief written statement.

This brief two-page statement summarizes the attached article which I recently published in Tax Notes Magazine.

Sincerely,

John A. Newman

Hearing on Fundamental Tax Reform
September 17, 1984

BEYOND THE 1985 TAX REFORM ACT

It's been said that taxes are what we pay for a civilized society. Our success at being "civilized" is as much reflected in how we apportion the burden of taxation, as in how we distribute public benefits. With annual deficits approaching $200 billion, the national debt climbing toward $2 trillion, and our tax system in a state of total disarray, there is an immediate need to re-examine our tax policy and to develop a simpler, fairer and more workable system of raising revenue.

Numerous proposals have been made for a "flat rate" income tax, a consumption tax or a European-style value added tax. These are all rather complex creatures of an earlier age which, at best, will provide only temporary relief. If the United States is to move successfully into the 21st century, a tax system suited to the times is imperative. In the near future, we will see fresh opportunities for more enduring fundamental tax reform emerging with the technological revolution.

Still somewhat novel, the computer is producing transformations in our society which will dwarf changes wrought by the industrial revolution. One change is in the development of electronic fund transfer systems (EFTS) as a substitute for cash, checks or other paper transactions. The most familiar example of EFTS is the popular automatic teller machine. A more recent phenomenon is the use of EFTS to make direct deposits of payroll and social security payments. By the end of this century, we could be living in a virtually cashless society, paying for most purchases with plastic debit cards verified through voice or handprint identification.

That's very interesting, you say, but what has that to do with tax policy and the national debt? The answer is that with the economy flowing largely through the veins of EFTS networks, there will exist a unique opportunity to draw taxes -- the lifeblood of society -- from the broadest conceivable tax base. One possibility is for a comprehensive, low-rate EFTS transfer tax as a potential substitute for the federal income tax. An EFTS transfer tax would penetrate deeply into the fabric of the everyday economy, co-exist with the lowest possible profile and, most importantly, raise considerable amounts of revenue. This pay-as-you-go "nickle and dime" tax would eliminate tax returns and other hassles associated with the "self assessment" process, the most irritating feature of the income tax. An EFTS transfer tax would be collected automatically at the time of each transfer and remitted immediately to the closest Federal Reserve Bank, saving taxpayers and the Treasury billions in administrative costs.

With the EFTS transfer tax, one's tax burden would be based on one's participation in the economy, perhaps the best measure of ability to pay. And the EFTS tax would be nearly impossible to avoid. With the convenience of EFTS networks, large denominations of currency could be removed from circulation, thus eliminating the underground economy. Bartering is inherently inefficient (that's why we developed money), unless conducted through organized exchanges which are easy to regulate. And, of course, the low rate of the tax is the best prevention against cheating.

Yes, you say, but what about financial privacy? What about George Orwell's 1984? Such concerns are well founded as we move toward a cashless era under an inherently intrusive system like the federal income tax. With the EFTS tax, by contrast, compliance efforts would be concerned solely with activity between accounts, not with either the purpose of the transfer or the identity of the account owners. Financial privacy, threatened under the income tax, could be improved if we shift toward a simple EFTS tax.

Finally, movement toward this type of tax is likely to improve the quality of our government. The Treasury Department could be granted statutory authority to monitor and adjust tax rates at short intervals, improving coordination between tax and monetary policy. This will give a helping hand to the Fed, which cannot tackle all our economic problems alone. It will also free Congress from the constant pressure from tax lobbyists pushing for special treatment. The result is a simple, fair, efficient and more responsive system of taxation in which everyone pays their fair share.

For a detailed discussion of this proposal, see Tax Notes Magazine, July 23, 1984, p.395.

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CONSTRUCTING A NEW TAX POLICY BASED ON THE COMPUTER

by John A. Newman

John A. Newman practices tax law in St. Louis, Missouri. He holds an LL.M in taxation from Georgetown University and a J.D. from Wake Forest University. The author wishes to acknowledge the help of George E. Harris, Jr. and John M. Sabin for their critical comments during the preparation of this article.

In this article, Newman suggests that a computer based electronic fund transfer system (EFTS) could provide a foundation for the imposition of a low rate, comprehensive transfer tax that could serve as a possible substitute for the federal income tax. He predicts that within ten years, an EFT network could be in place that could generate more revenue than the federal income tax. Such a tax could be collected automatically at the time of all transfers and would eliminate various individual, corporate, partnership, trust and estate tax returns under the present income tax system.

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INTRODUCTION

The development and implementation of effective tax policy is as pressing a concern today as it was two thousand years ago when a burgeoning national budget compelled Augustus Caesar to levy, for the first time in 150 years, a simple broad-based excise tax of one percent on all purchases by Roman citizens.[1] Today, the United States faces a revenue shortfall which would make Caesar cringe: annual budget deficits are approaching $200 billion and by 1986 the national debt may exceed two trillion dollars, or $8,800 for every man, woman and child in this country.[2] These circumstances undoubtedly contribute to the growing concern over the ability of the income tax system, as presently constituted, to achieve its primary function of raising revenue.[3]

[1]*See* Gibbon, *The Decline and Fall of the Roman Empire*, Vol. I, 140-43 (1787) (Modern Lib. Ed.). As Gibbon explains, "The excise, introduced by Augustus after the civil wars, was extremely moderate, but it was general. It seldom exceeded one per cent; but it comprehended whatever was sold in the markets or by public auction, from the most considerable purchase of lands and houses to those minute objects which can only derive a value from their infinite multitude and daily consumption." *Id.* at 141.

[2]*See* Manvel, *Tax Collection Trends*, *Tax Notes*, February 6, 1984, p. 532, 535. The two trillion dollar national debt anticipated for 1986 represents a doubling of the debt from approximately one trillion dollars in 1981. *Id.* Of all the presidents since 1929 only one, President Truman, averaged an overall surplus during his administration. The most recent surplus during any one year occurred in 1969 during President Nixon's administration. *See generally*, Manvel, *Background for those Record Deficits*, *Tax Notes*, January 2, 1984, p. 56-57.

[3]Treasury Secretary Regan recently remarked: "The tax law has accumulated many patchwork provisions, often designed to meet temporary needs of particular interest groups, that have added to the complexity of the system and distorted economic choices." The Secretary promised to deliver to the President proposals for fundamental tax reform by December, 1984, a time frame which emphasizes the political nature of the process. *See* Statement of Donald T. Regan, *Tax Notes*, February 6, 1984, p. 439-40.

The technological framework for EFT networks, which could be in place within ten years, furnishes a unique opportunity for the development of an effective tax policy.

SPECIAL REPORT

Reaffirming the notion that progress sometimes entails a return to "basics," numerous proposals have been made for a radical restructuring of the present system into a flat-rate income tax or, alternatively, for a complete abandonment of the income tax in favor of a consumption or value-added tax.[4] Although these proposals offer politically-viable options for interim tax reform for the next several years, they overlook fresh opportunities for more enduring fundamental tax reform which are now emerging with the technological revolution.

The combination of exemptions for the poor and tax preferences for the rich have converted the theoretically attractive income tax into a largely proportional tax on the middle class.

Although still somewhat novel, the computer will produce transformations in our society which are likely to make changes wrought by the industrial revolution pale by comparison. Among these changes, the development of electronic fund transfer systems (EFTS) are moving us rapidly toward a cashless era in which nearly all transactions will be handled through computer accounts.[5] The technological framework for EFT networks, which could be in place within ten years, furnishes a unique opportunity for the development of an effective tax policy. This article focuses on one such possibility: a comprehensive, low rate EFT transfer tax as a potential substitute for the income tax.

In order to consider this proposal in its proper context, the following discussion is directed toward three objectives: first, to review the traditional criteria for a "good" tax and the failure of the present system to fulfill those goals; second, to explore the developing electronic fund transfer technology and the associated risks and benefits of a cashless society and, finally, to evaluate the potential for an EFTS tax in light of the traditional objectives of sound tax policy.

DISCUSSION

A. Evaluation of the Federal Income Tax

There are at least four criteria traditionally employed in evaluating the qualities of a particular tax. First, a tax should be simple and easily understood by those who must comply with its terms. Second, a tax should be equitable, imposing both equal burdens upon similarly-situated taxpayers (horizontal equity) and relatively different burdens on taxpayers in different financial circumstances (vertical equity). In addition, a tax should be efficient, or a neutral consideration in the allocation of resources as well as an effective method of raising revenue. Finally, a tax should be a responsive tool of fiscal control in order to help stabilize fluctuations in the economy.[6] The following discussion examines the current state of the income tax in light of these traditional objectives.

1. Simplicity. Even a cursory evaluation of the present tax system is enough to confirm Professor Surrey's observation that, "[our] tax policy is in total disarray."[7] The incomprehensibility of the income tax is attributable

[4]The income tax was first introduced in this country briefly as a wartime measure during the American Civil War. Incomes from $600 to $5,000 were taxed at five percent; from $5,000 to $10,000 at 7.5 percent, and incomes exceeding $10,000 were taxed at 10 percent. The tax expired shortly after the war. In 1894, the income tax was again enacted, but was struck down as unconstitutional in *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895). *See* U.S. Const. Art. I, section 8, cl. 1; section 2, cl. 3; secton 9, cl. 4 (proscribing direct, unapportioned tax). *Pollock* was overturned with the passage of the Sixteenth Amendment in 1913, at which time our current income tax was enacted. *See generally*, McCarthy, *The Federal Income Tax* 3 (3d Ed. 1968). Legislative history to the original 1913 Act indicates that similar taxes already had been adopted by 52 foreign countries and states, including France and Russia. *See*, H.R. Rep. No. 5, 63d Cong., 1st Sess., *reprinted* in 1939-1 (Part II) C.B. 1. Today, the federal corporate and individual income taxes account for approximately 44 percent of total federal revenues (8 percent and 36 percent, respectively), the single largest source of revenue. Social insurance receipts account for 29 percent; excise taxes, 4 percent; miscellaneous taxes, 3 percent and, significantly, borrowing will produce the remaining 22 percent of federal revenues. *See* Fiscal Year 1985 Budget Estimates, *reprinted* in Manvel, *Tax Collection Trends*, *Tax Notes*, February 6, 1984, p. 532-34. Numerous bills have been introduced in Congress to modify the existing income tax by broadening the tax base and reducing rates. *See, e.g.*, Senators Bradley (S. 1421), DeConcini (S. 557), Hatfield (S. 2158) and Quayle (S. 1040); Representatives Crane (H.R. 542), Dreier (H.R. 1770), Gephardt (H.R. 3271), Hance (H.R. 2564), Hansen (H.R. 170), Panetta (H.R. 2520), and Paul (H.R. 1664 and H.R. 2137). *See* Hatfield, *Tax Reform: It's Time to Fulfill the Promise*, *Tax Notes*, January 30, 1984, p. 407, 408, n. 7. Other proposals have been made to eliminate the income tax in favor of a consumption tax; *see, e.g.*, Feldstein, *Tax Reform and Capital Formation*, *reprinted* in *Tax Notes*, January 24, 1983, p. 347, or a value-added tax. *See* McLure, *The Value-Added Tax: Effects on Productivity and Equity*, *Tax Notes*, September 26, 1983, p. 971.

[5]Electronic Fund Transfer Systems (EFTS) are perhaps best described as a host of financial services based on computerized transmission and recordkeeping as a substitute for cash, checks and other paper transactions. They include (1) automated teller machines (ATMs) (the now-familiar 24-hour banking computers which provide customers with easy access to their accounts to make withdrawals, deposits or transfers among accounts), (2) automated clearing houses (ACHs) (computerized inter-bank transfer systems providing paperless transfers of debits and credits among accounts), (3) point-of-sale terminals (POS) (computerized payment systems located in retail establishments), (4) telephone bill paying service (TBP) (permits customers to pay pre-authorized recurring bills via telephone from home). *See* Beguai, *The Cashless Society: EFTs at the Crossroads* 4-6 (1981); Schroeder, *Developments in Consumer Electronic Fund Transfers*, Fed. Res. Bull. 395 (June, 1983); Tauber, *The Emergence of the Electronic Fund Transfer System: Consumer Protection, Federal Antitrust, and Branch Banking Laws*, 10 Ohio N.U.L.Rev. 323, 325-27 (1983).

[6]See Pechman, *Federal Tax Policy* 5 (Rev. Ed. 1971); *Setting National Priorities: The 1984 Budget* 173-200 (Brookings Inst. 1983); Gensheimer, *Revising the Individual Income Tax*, *Tax Notes*, Aug. 8, 1983, p. 427, 428; Hatfield, *Tax Reform: It's Time to Fulfill the Promise*, *Tax Notes*, Jan. 30, 1984, p. 407, 411.

[7]*See*, Surrey, *Our Troubled Tax Policy: False Routes and Proper Paths to Change*, *Tax Notes*, Special Report Supplement (1981), p. 3.

to at least two factors. First, the system is conceptually difficult. For example, a tax based on "net income" requires an allowance for business deductions, and a corresponding denial of deductions for personal expenditures. The inherent difficulty of distinguishing between business and personal expenses is evidenced by the continued inability to resolve the treatment of employee fringe benefits, a struggle which has endured for 70 years.[8] There also are complications arising from application of an annual accounting period, exacerbated by the progressive rate structure which rewards deferral of income and acceleration of deductions, and by the need to apply the tax to unaccommodating business entities, such as partnerships.[9] Despite these conceptual hurdles, Congress was confident when it passed the original 1913 Revenue Act that these difficulties would be resolved over time:

> "[a]s soon as this tax and its administrative machinery become fairly understood by the people and adjusted by the country its operation and effects will meet with as much general satisfaction as any tax law.... All good citizens, it is therefore believed, will willingly and cheerfully support and sustain this [tax]...."[10]

The foregoing assurances, however, overlooked the second major defect contributing to the complexity of the income tax: its inherent susceptibility to political manipulation. Congress soon discovered that deductions and exemptions offered a politically attractive means of conferring special treatment, by virtue of the difficulty of measuring the benefit of a particular tax preference and removal of such indirect subsidies from the annual budgetary process.[11] The proliferation of tax preferences, whether to advance desirable social policy or merely to cater to political constituents, has escalated in recent years: the annual tax expenditure budget is now estimated at $265 billion.[12] With hundreds of tax preferences representing 70 years of shifting political fortune currently on the books, it is not surprising that the Code has deteriorated into a plethora of inconsistencies. In terms of simplicity, then, the income tax has been an unmitigated failure, an observation confirmed by the need by over 40 percent of taxpayers to obtain professional assistance in the preparation of tax returns at a cost exceeding $1 billion.[13] The following discussion evaluates the fairness of the income tax, traditionally considered a primary justification for its complexity.

The latest round of compliance measures is being imposed on taxpayers already bewildered by an incomprehensible tax system.

2. Equity. As mentioned earlier, a tax generally is considered equitable if it imposes commensurate burdens on similarly-situated taxpayers (horizontal equity) and differentiates in its burden on taxpayers participating in the economy to a greater or lesser extent (vertical equity). In this latter regard, the federal income tax is designed in theory to be progressive, imposing marginally greater tax burdens with improvements in one's ability to pay. The zero bracket amount and exemptions for dependents eliminate tax for those with low earnings; for those with more income, the tax rate schedules are structured with marginal rates ranging from 12 percent on incomes approaching $5,500 to 50 percent on income exceeding $162,400.[14] Progressively higher tax burdens are justified

[8]A number of fringe benefits have been exempted from taxation by statute, including pension contributions, certain insurance premiums, child care expenses, and employee educational expenses. *See* I.R.C. sections 401-15, 219 (pensions); 79, 104, 106 (insurance); 129 (child care); 127 (employee education). Nonstatutory fringe benefits present difficult administrative issues of definition, valuation, liquidity and taxpayer morale, in light of the inherent difficulty of separating incidental working conditions from outright compensation. In 1978, Congress imposed a moratorium on the issuance of regulations on fringe benefits. *See* section 1, P.L. 95-427, which was extended to run through 1983, section 1, P.L. 96-167; Sec. 801, P.L. 97-34. Among the nonstatutory items are employer discounts, free use of company equipment, travel passes, and employee parking privileges. *See* Guttman, *The Single-Rate Income Tax: Policy Questions and Technical Issues*, *Tax Notes*, November 14, 1983, p. 539, 542-43, for a more thorough discussion.

[9]Subchapter K of the Code is a complex attempt to mesh tax law with the competing entity and aggregate theories of partnership law. *Compare Diamond v. Commissioner*, 56 T.C. 530 (1971) (aggregate theory used to explain taxability on receipt of interest in partnership in return for services), *aff'd*, 492 F.2d 286 (7th Cir. 1974); I.R.C. section 701 (1976) (persons carrying on businesses as partners are liable for tax in their individual capacities); *Id.* section 702 (pass-through of income, deductions and credits); *Id.* section 705 (partnership basis rules) *with* I.R.C. section 706 (1976) (partnership has its own taxable year); *Id.* section 708(b) (partnership has continuous life); *Id.* section 707(a) (partner may deal with partnership in arm's-length transaction). *See also* A. Willis, *Partnership Taxation, section 27.04* (3d ed. 1981).

[10]H.R. Rep. No. 5, 63d Cong., 1st Sess., *reprinted* in 1939-1 (Part II) C.B. 1, 3.

[11]The first tax expenditure budget was computed in 1968 and involved 40 items at a cost of approximately $44 billion. Today, the expenditure budget has ballooned to several hundred items at a total cost for 1985 estimated at $266 billion, as compared to an expected deficit of $180 billion. *See Revenue Loss Estimates for Tax Expenditures by Function*, *Tax Notes*, Feb. 6, 1984, p. 538-39, Table G-2. *See also* Hatfield, *supra* note 4, at 411 where the author observes that individuals with earnings in the top one percent enjoy approximately 13 percent of certain tax expenditure benefits. *See* Congressional Budget Office, *Tax Expenditures* (November, 1982), p. xiv.

[12]Among the largest tax expenditures currently in force are the net exclusion of pension contributions and earnings ($56 billion); deductibility of home mortgage interest ($25 billion); deductibility of nonbusiness state and local taxes other than on personal residences ($22 billion); exclusion of employer contributions for medical insurance premiums ($20 billion); special capital gain rates ($16 billion) and deductibility of interest on consumer debt ($11 billion), for a total cost of $150 billion in fiscal year 1985. *See Revenue Loss Estimates for Tax Expenditures by Function*, *Tax Notes*, Feb. 6, 1984, p. 538-39, Table G-2.

[13]*See* Congressional Budget Office, *Revising the Individual Income Tax*, (July, 1983), p. 2; *cited* in Hatfield, *supra* note 4, at 409.

[14]See I.R.C. section 1(a)(3). These rates represent a substantial reduction from a top rate of 70 percent on unearned income in affect as recently as 1981.

under the theory of ability to pay; opponents argue that it is merely a pretext to "soak the rich."[15]

Regardless of one's philosophical views, the theoretical progressivity of the income tax is not borne out in its actual operation. In fact, the income tax is highly regressive in its complete exemption from tax of municipal bond interest and the special 60 percent deduction for long-term capital gains.[16] Accelerated depreciation policy and—ironically—the steep progressivity of the tax rates have contributed to the proliferation of various tax shelters offering further opportunities to circumvent progressive taxation.[17] Moreover, the current system only reaches income—it does not even attempt to tax economic power associated with accumulated wealth, which obviously bears on one's ability to pay. In practice, then, the combination of exemptions for the poor and tax preferences for the rich have converted the theoretically attractive income tax into a largely proportional tax on the middle class.[18] Growing dissatisfaction with the system's failure to achieve vertical equity also has been fueled by the interplay of inflation and progressive tax rates. This produces "bracket creep," an unlegislated tax increase which, again, falls primarily on the middle class.[19]

In addition to a lack of vertical equity, the income tax does not impose equal burdens on similarly-situated taxpayers. For example, the deductibility of interest payments by homeowners places tenants having equal earnings at a significant disadvantage,[20] while individuals living off wages pay substantially higher taxes than individuals earning equal amounts of certain investment income. In the business sector, depreciation policy, tax preferences and various accounting practices have produced a wide disparity in effective corporate tax rates. Industries such as rubber, trucking and tobacco paid effective rates exceeding 35 percent in 1982, while other industries, such as chemicals, actually enjoyed a subsidy of nearly 18 percent.[21] There also is a growing divergence between corporate and individual tax receipts as a percentage of total federal revenues. The corporate share of total revenues declined from 28 percent in 1950 to 8 percent in 1982 while individuals' share of the burden increased during the same period from 39 percent to 49 percent.

It has been estimated that the Treasury Department could save 15.6 cents per payment if it substituted direct automated clearing house transfers for monthly social security checks.

In light of the foregoing, it is rather evident that the impact of the income tax system varies greatly according to type of income, nature of business and form of ownership. As such, the income tax provides neither equal treatment across income classes, nor progressivity among classes.

3. Efficiency. A tax is efficient if it is a neutral factor in the allocation of resources. A secondary aspect of efficiency is whether the tax is an effective method of raising revenue. With regard to neutrality, the present income tax system creates enormous misallocations of resources. For example, the deductibility of interest expense encourages immediate debt-financed consumption at the expense of savings and, as one commentator has noted, is partly responsible for the development in this country of a "debtor mentality."[22] Moreover, the tax system also undermines our traditional work ethic insofar as high marginal tax rates impose a disincentive on additional

[15]For a thorough discussion of the relative advantages of progressivity over proportionality, *see* Blum & Calvin, *The Uneasy Case for Progressive Taxation* (1953); updated in Blum, *Revisiting the Uneasy Case for Progressive Taxation*, 60 Taxes 16 (1982). Legislative history to the original 1913 Revenue Act explains Congress' dissatisfaction with the existing system of proportionate excise taxes: "These taxes rest solely on consumption. The amount each citizen contributes is governed, not by his ability to pay tax, but by his consumption of the articles taxed. It requires as many yards of cloth to clothe, and as many ounces of food to sustain, the day laborer, as the largest holder of invested wealth; yet each pays into the Federal Treasury a like amount of taxes upon the food he eats, while the former at present pays a larger rate of tax upon his cheap suit of woolen clothing than the latter upon his costly suit. The result is that the poorer classes bear the chief burden of our customhouse taxation." *See* H.R. Rep. No. 5, *reprinted* in 1939-1 (Part II) C.B. 1. The forcefulness of both points is reduced somewhat by the development of the modern welfare state and by the fact that the income tax, in theory or practice, has never attempted to reach accumulations of invested wealth, *per se*.

[16]I.R.C. sections 103, 1202.

[17]During consideration of the 1976 Tax Reform Act, a study was made of some of the practical effects of tax shelters. The study revealed, for example, that a corporate executive with $450,000 of income paid tax at an effective rate of 0.3 percent, another executive paid 3.5 percent on a salary of $532,000, a lawyer paid no tax on $151,000, and a dentist paid no tax on $156,000 of income. Staff of Joint Comm. on Taxation, Tax Shelter Investments: Analysis of 37 Individual Income Tax Returns, 94th Cong., 2d Sess. 1 (Comm. Print 1976). Congress responded to these horror stories by enacting the "minimum tax" to exact a minimal level of taxation from investors engaged in ongoing shelters, the "depreciation recapture" rules to prevent escape from certain shelters at capital gain rates and the "at risk" rules to place a lid on the use of loss deductions out of proportion to actual economic investment. *See* sections 55-58; 1245; 1250; 465. Real estate investments, however, were given a special exemption from the at risk rules and it is this area that today offers the best shelter opportunities. *See* section 465(c)(3)(D).

[18]*See* Peckman and Okner, *Who Bears the Tax Burden?* (1974), where it is argued that the current system of income tax is only mildly progressive. *See also* Guttman, *The Single Rate Income Tax: Policy Questions and Technical Issues*, *Tax Notes*, Nov. 14, 1983, p. 539, 554, where the author points out the frequently overlooked fact that FICA taxes, which exceed the income tax burden for approximately one-half of the work force are levied on gross wages and, with the ceiling on covered wages, tend to be rather regressive.

[19]Implementation of "indexing" of tax rate tables, scheduled to begin in 1985, is designed to curtail the effects of inflation and prevent "bracket creep." *See* I.R.C. section 1(f).

[20]I.R.C. section 163. In 1985 this tax expenditure is expected to cost the government approximately $25 billion. *See Revenue Loss Estimates for Tax Expenditures by Function*, *Tax Notes*, February 6, 1984, p. 538.

[21]*See*, *Average Effective Corporate Tax Rate Pegged at 16 Percent*, *Tax Notes*, November 21, 1983, p. 654.

[22]*See* Hatfield, *supra* note 4, at 409.

efforts to earn money.[23] In the business context, the deductibility of interest and nondeductibility of dividends encourages highly leveraged corporate capital structures. The availability of accelerated depreciation having no realistic relationship to actual economic deterioration underlies the proliferation of business ventures having no economic benefit aside from tax advantages. For example, as stated recently by the Senate Finance Committee:

> [D]espite the glut of rental housing in certain Sun Belt regions, syndicated tax shelters have continued to overbuild . . . because of the generous depreciation deductions and other tax benefits. . . . The nation's economic growth is reduced to the extent that investment is diverted from more productive investments, with a higher pre-tax rate of return."[24]

In light of the foregoing, then, it is rather apparent that the income tax has not been a neutral consideration in the allocation of resources.

The EFTS transfer tax is based on one's ability to pay, measured not by net income or consumption, but rather by the degree to which an individual participates in the economy.

In addition to a lack of neutrality, the income tax has not been a particularly effective method of raising revenue. Theoretically, voluntary self-assessment at the initial stages of the compliance process would seem to provide a unique opportunity to administer a tax without undue government involvement. The success of such a system, of course, hinges entirely upon the collective willingness of individuals to disregard their natural inclinations to avoid tax. The naivete of this unfortunate assumption—tantamount to having the fox look after the chickens—is exposed by three decades of public opinion polls confirming that, regardless of the true level of taxation, taxes have always been considered too high.[25] And taxpayers have never hesitated to act on their perceptions. For example, one study concludes that the underground economy actually peaked during World War II when it approached 8 percent of GNP. Imposition of wage withholding reduced the figure below 5 percent until 1975 when it began escalating to the current level, which has been estimated at 7.5 percent of GNP, or $222 billion.[26] Unlike wage withholding during the 1940s, the latest round of compliance measures is being imposed on taxpayers already bewildered by an incomprehensible tax system. As such, increased frustration of coping with these additional complexities might actually contribute to deteriorating taxpayer morale, the cornerstone of a voluntary reporting system of taxation. Increasingly, the present system is being regarded as a tax on honesty, which fewer individuals are prepared to pay.

4. Stability. A final objective of tax policy is to produce a tax which helps stabilize fluctuations in the economy, either automatically or through manipulation of tax rates. In theory, the federal income tax has an automatic stabilizing effect by virtue of the progressive rate structure. As one's adjusted gross income declines, tax rates decline more quickly, preserving a greater measure of disposable income available to stimulate the economy. Conversely, as adjusted gross income increases, tax rates impose progressively higher taxes, stemming the rise of discretionary income and preventing inflation. The overall effect is a more stable pattern of consumption.[27]

In practice, however, it seems unlikely that the income tax conforms to its theoretical model. As incomes increase beyond a certain level, taxpayers enjoy the freedom to engage in effective tax planning. Investments in exempt bonds, conversion of ordinary income into capital gains, deferred compensation arrangements and participation in various tax shelters offer opportunities to circumvent progressive tax rates. The brunt of the tax burden tends to fall on middle class taxpayers who are confronted with effective tax rates approaching proportionality. Moreover, to the extent additional earnings in the middle class sector arise from the popular practice of moonlighting at second jobs (maintained "off the books"), the present system actually might have a destabilizing effect on the economy.

A second factor in economic stabilization is the responsiveness of the income tax as a tool for effectuating changes in fiscal policy. In this regard, the current payment system implemented largely through wage withholding provides a mechanism for a quick response to policy changes.[28] The rub, unfortunately, is that unlike monetary policy, which enjoys close monitoring from the relatively isolated Federal Reserve Board, changes in fiscal policy depend on the tax legislative process, a laborious effort which can take months or years to complete.[29] As such, even if the present income tax were

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[23]On the other hand, it could be argued that some taxpayers actually may be motivated to work harder in response to the progressive rate structure, in order to take home a target level of wages.

[24]*See* Senate Finance Committee Explanation of Deficit Reduction Act of 1984, Sec. 171.

[25]*See* Henry, *Noncompliance with U.S. Tax Law—Evidence on Size, Growth, and Composition*, 37 Tax Law. 1, 44 (Fall, 1983), *citing* G. Gallup, The Gallup Poll (1980). Mr. Henry's fine article provides an extensive discussion of the criteria and assumptions used in various studies attempting to estimate the size of the underground economy. A conservative consensus estimate is that the underground economy (exclusive of illegal prostitution, drug and related trade) exceeded $100 billion in 1976, or 13 percent of total reported and unreported taxable income, and has been growing at an average rate of between 5-8 percent since 1976. 37 Tax Law. at 51-52. Interestingly, the author concludes, "The overwhelming share of . . . noncompliance is attributable to property and entrepreneunal incomes [such as interest, dividends, capital gains, rents and royalties]. This contradicts the wide-spread impression that noncompliance is largely the province of busboys, cabbies, field hands, and street vendors." *Id.* at 53.

[26]*See* Tanzi, *The Underground Economy in the United States: Annual Estimates, 1930-80*, 30 Int. Mon. Fund Staff Paper, 283, 297-300 (June, 1983). The $222 billion figure is based on a recent Census Bureau Study reported in *Tax Notes*, December 26, 1983, p. 1236.

[27]*See* Pechman, *Federal Tax Policy* 63 (Rev. ed. 1971).

[28]*Id.*

[29]*Id.* at 32, 49. For a critique of the tax legislative process, *see* Surrey, *Our Troubled Tax Policy: False Routes and Proper Paths to Change*, *Tax Notes*, Special Report Supplement (1981), p. 9-11.

capable of stabilizing the economy, its responsiveness remains largely encumbered.

5. Summary. As the foregoing discussion indicates, our present income tax system has failed to achieve the traditional objectives of simplicity, fairness, efficiency and, possibly, stability. Interestingly, the system's failure to meet the latter three objectives probably is attributable to its inherent complexity, compounded beyond recognition by decades of undisciplined use of the system to implement social policy or, on a more mundane level, to cater to political constituents. The result is a tax system which one recent President declared to be "a disgrace to the human race."[30] The following discussion explores an opportunity created recently by the technological revolution to restructure our tax policy into a more workable system.

Religious, charitable and similar organizations presently exempted from the income tax would not be exempted from the EFTS tax.

B. EFTS Networks: Toward a Cashless Society.

"We should all be concerned about the future," wrote scientist Charles F. Kettering, "because we will have to spend the rest of our lives there."[31] The development of the computer will have an impact on our lives which is expected to make the industrial revolution of the last century pale by comparison. Already, computers are affecting nearly every major industry in America, including transportation, commerce, the professions and banking.[32] In this latter regard, computers are responsible for the creation of electronic fund transfer systems (EFTS), representing a host of financial services based on electronic transmission and recordkeeping as a substitute for cash, checks and other paper media. The development of a virtually cashless society is not far off: already over 75 percent of all transactions (by amount) are effectuated electronically, with cash transactions amounting to less than 10 percent of the total.[33]

The emergence of this cashless era is rather timely, insofar as it comes at a period when our present tax system is in a state of disarray and the government is searching for avenues of improvement.[34] In order to provide a framework for the consideration of opportunities for tax reform offered by these recent technological advances, the following discussion is directed toward three objectives: first, to review the various types of EFT systems currently available; second, to evaluate the progress being made in the development of EFT networks; and, finally, to explore briefly some of the potential risks and benefits of a cashless society.

1. Types of Electronic Fund Transfer Systems. Current EFTS technology finds its genesis in the creation of magnetic ink character recognition which was adopted in 1956 by the American Bankers Association. Magnetic ink printed on the bottom of checks computerized the handling of paper transactions.[35] Today, EFT systems have moved one step further to eliminate paper as a transaction medium. There are now several types of EFTS in use. Perhaps the most familiar EFTS is the automated teller machine (ATM) which allows bank customers 24 hour access to their accounts. ATMs may be used to withdraw or deposit cash or, more recently, to transfer funds between accounts. Customers gain access to the system by inserting a plastic card containing a magnetic strip and by entering a secret personal identification number (PIN). User-friendly programs then direct the customer with a series of questions. So far, public response to ATMs has been encouraging: from 1981 to 1982 the number of ATMs increased 38 percent to over 36,000 machines while total volume increased 74 percent to an annual rate exceeding 3 billion transactions.[36] ATMs provide immediate documentation, greater access

[30] Acceptance speech of Presidential Candidate Jimmy Carter at the Democratic National Convention, July 15, 1976, *reprinted* in Guttman, *The Single-Rate Income Tax: Policy Questions and Technical Issues*, *Tax Notes*, November 14, 1983, p. 539.

[31] *See* Capron & Williams, *Computers and Data Processing* 3 (1982).

[32] In transportation, for example, computers improve efficiency in airline reservations, increase safety in air traffic control, reduce human errors in piloting, and have proven indispensible to the space shuttle program. In business, computers are behind the development of scanners and the development of a Universal Product Code which improves efficiency and inventory control. In farming, computers provide decentralized sources of information in remote areas, stemming the movement toward large centralized farming. In health and medicine, computerized axial tomography scanners (CAT Scans) provide video displays or print-outs of cross sections of the human body; computer programs help diagnoses and treatment of patients and microprocessor-aided bionic limbs currently under development will alleviate handicaps. In government, national defense, revenue collection, commerce, agriculture, environmental protection and justice are all aided by computers. In the law, computers have been developed to facilitate research and many courts are using computers to improve docket control. In education, computer-assisted instruction (CAI) programs are providing individualized instruction and testing. In the stock market, daily volume of 11 million shares nearly caused a collapse in 1970; today computers facilitate the handling of over 100 million shares routinely. *See generally* Capron & Williams, *Computers and Data Processing* 357, 430-31 (1982).

[33] In 1977, EFTS transfers totalled nearly $35 trillion, compared to $11 trillion for all paper transactions, including cash, checks and bank card transactions. Cash payments totalled $236 billion. In terms of the number of transactions, there were nearly 260 billion cash payments, or 88 percent of the total. Electronic payments totalled only 130 million or .04 percent. *See* Tauber, *The Emergence of the Electronic Fund Transfer System: Consumer Protection, Federal Antitrust, and Branch Banking Laws*, 10 Ohio N.U.L. Rev. 323, 324 (1983). There currently is circulating outside banks and government approximately $130 billion of U.S. currency. Aside from legitimate purposes, the use of cash is central to the underground economy and to the illicit drug trade. *See* Henry, *Noncompliance with U.S. Tax Law—Evidence on Size, Growth, and Composition*, 37 Tax Law. 1, 39-42 (Fall 1983).

[34] *See* Statement of Donald T. Regan, *reprinted* in *Tax Notes*, February 6, 1984, p. 439, indicating the need to consider alternatives for fundamental reform of the income tax system. Proposals are to be delivered to the President by December, 1984.

[35] *See* Tauber, *supra* note 33, at 324, n. 7. In 1960 there were 12 billion checks drawn in the United States. By 1985, the figure is expected to reach 54 billion checks. *Id.* at 323, n. 2.

[36] *See* Schroeder, *Developments in Consumer Electronic Fund Transfers*, Fed. Res. Bull. 395, 396 (June, 1983).

and convenience, and have proved to be fairly safe and reliable.[37]

One step beyond ATMs, electronic fund transfers are being made through point of sale terminals (POS) located primarily in retail establishments. In a POS transaction, the customer inserts a plastic card into a terminal and enters a secret PIN into a keypad. The computer automatically debits the customer's account, while crediting the merchant's account for the same amount. As with ATMs, the transaction is immediately documented but, unlike ATMs, the transaction is entirely cashless.[38]

A third type of EFTS allows bank customers to pay recurring bills by telephone. Truly decentralized, the customer merely telephones the bank and consents to certain pre-authorized transfers, such as mortgage payments. One disadvantage of telephone bill-paying is a lack of immediate documentation.[39]

In addition to the foregoing, financial institutions during the early 1970s spurred development of automated clearing houses (ACH) to help cope with the paper glut. ACHs provide both check truncation systems, where the depository institutions retain checks while transmitting the relevant message electronically to receiving banks, as well as more advanced services whereby organizations having, e.g., large payrolls, electronically authorize ACHs to credit employee accounts directly.[40] Currently, there are over 30 ACHs with a total volume in 1982 of 408 million transactions, an increase of 30 percent from a year earlier.[41] The use of ACHs offers considerable savings: it has been estimated that the Treasury Department could save 15.6 cents per payment if it substituted direct ACH transfers for monthly social security checks.[42]

2. EFTS Networks. The creation of regional, national and international EFTS networks is central to the development of a cashless society. Generally, networking requires standardization of procedures and cooperation among firms to reduce costs.[43] In Europe, where the regulatory climate is relatively liberal, members of Eurocheque recently reached agreement on industry standards in the development and sharing of automated teller machines and point of sale terminals. Eurocheque is a consortium of 15,000 member banks with a customer base holding 26 million cards.[44]

For both inbound and outbound transfers, the EFTS tax will be imposed at the full rate, but there would be a credit of up to one-half the normal rate for any taxes actually paid to a foreign government.

In this country, financial institutions face numerous regulatory obstacles to the development of regional and national EFT networks, including state limitations on branch banking, federal antitrust restrictions and uncertainties in the areas of consumer protection and industry standards in the handling of EFT transactions.[45] Nevertheless, through ingenuity and a growing governmental awareness of the need to encourage networking, banks have succeeded in developing EFT networks in several states. For example, in California, five leading banks have created Interlink, a system which will allow their 6 million cardholders to share automated teller machines and point of sale terminals. Similarly, 10 major Florida banks have formed Interchange Group, an EFT network serving 4 million cardholders.[46] As deregulation continues, cross-industry cooperation is likely to broaden EFT networks. Paine Webber, Inc. recently arranged to provide its customers access to brokerage accounts through a nationwide network of automated teller machines operated by MasterCard International.[47] As these developments indicate, the transition toward a cashless society is rapidly gaining momentum both here and abroad. The following discussion explores briefly some of the challenges and benefits of a cashless society.

3. Risks and Benefits of a Cashless Society. Movement toward a cashless society is likely to produce a number of improvements, it also is likely to exacerbate certain problems which have been growing with the computer

[37]Immediate documentation of ATM transactions, in the form of a receipt, is required by the Electronic Funds Transfer Act, 15 U.S.C. section 1693. The receipt must contain the amount of the transfer, the type of transfer, the account involved (by code or number), the location or identification of the terminal, and the identity of any third party involved. 15 U.S.C. section 1693d(a)(1)-(5). In the case of pre-authorized EFTS transactions by telephone, the customer must be given the opportunity to verify whether the transaction occurred and transactions must be reflected in periodic statements. 12 C.F.R. section 205.10(a)(iii)(1983); 15 U.S.C. section 1693d(c). *See generally*, Tauber, *supra* note 33, at 330-31.

[38]There are three types of POS systems: the simple model, the transition model and the network model. The simple model, as its name implies, is relatively unsophisticated, allowing customer and merchant to use the system only if both maintain accounts at the same bank. The transition model accommodates several banks and merchants in a relatively limited area. The network model, by using computer switching stations, facilitates participation by thousands of merchants and banks. *See* Bequai, *The Cashless Society: EFTS at the Crossroads* 31-32 (1981). In 1981 the more sophisticated POS terminals were priced in the neighborhood of $2,000-$2,500. *Id.* at 41.

[39]*But see*, *supra* note 37, regarding periodic statements of transactions.

[40]Corporations and the federal government are moving rapidly toward the use of ACHs for direct deposit of employee payrolls. *See* Bequai *supra* note 38, at 29-30. Of the more than 49 million payments of federal salaries and benefits in December, 1982, nearly 18 million, or 36 percent, were made by EFT. *See* Schroeder, *supra* note 36, at 396.

[41]*See* Tauber, *supra* note 33, at 325, n. 10; Schroeder, *supra* note 36, at 396.

[42]*See* Tauber, *supra* note 33, at 325, n. 12.

[43]For an excellent article on the theory of networking, including applications to the railroad, telephone and EFTS industries, *see* Carlton & Klamer, *The Need for Coordination Among Firms, with Special Reference to Network Industries*, 50 U. Chi. L. Rev. 446 (1983).

[44]*See*, *Banking Tomorrow*, The Banker 65 (December, 1983).

[45]For an evaluation of these laws in the context of EFTS networking, *see* Tauber, *supra* note 33.

[46]*See*, *Debit Cards: Banks Begin to Widen the Network*, *Business Week* 114 (September 12, 1983).

[47]*See*, Hertzberg & McMurray, *Some Banks, Brokers Form Business Ties*, *Wall St. J.*, Feb. 15, 1984, at 27, col. 3.

age. In the area of security, for example, cashless transactions will eliminate counterfeiting of U.S. currency, a $58 million problem in 1981.[48] It also will reduce robbery, burglary and drug trafficking, all of which depend to some extent on the anonymity of cash transactions. On the other hand, as currency counterfeiting and robbery decline, bank card counterfeiting and computer theft will rise. Visa and MasterCard International reported card fraud losses of $100 million for 1982.[49] Moreover, while the average bank robbery involves $3,200, and the average bank fraud, $23,000, the average computer crime involves $500,000.[50] Security is being strengthened by the development of encryption devices for computers, while bank card companies are experimenting with sophisticated holograms and laser printing techniques to render counterfeiting more difficult, and more generalized use of personal identification numbers, voiceprint and handprint devices to ensure greater security at the point of sale.[51] Moreover, Congress currently is considering stricter computer crime legislation.[52]

The tax generally would be imposed upon the transferee, unless the parties by agreement shifted the burden to the transferor.

In the area of privacy, movement toward a cashless era obviously carries Orwellian overtones characteristic of a computer society in general. In this regard, Congress has demonstrated an interest in monitoring closely potential threats to privacy, particularly with respect to the security and use of financial information. It seems likely that this effort will continue.[53]

In terms of efficiency, a cashless society will eliminate much of the cost associated with paper transactions, currently estimated at $14 billion a year.[54] EFTS networks will increase the flow of market information, and will provide customers with ready access to their accounts, improving market competition and consumer services. Finally, a major benefit of EFTS technology, to which the remainder of this article is devoted, is in the opportunity it provides for the development of an effective tax system.

C. The EFTS Transaction Tax: A Proposal

In order to provide an overview of the proposal for an EFTS transaction tax, the following discussion is directed toward two objectives: first, to explain the specifics of the proposal, including the underlying theory, the tax base, the incidence of the tax, the tax rate structure, compliance and collection machinery, the potential revenue effect, and transitional considerations. The second part of the discussion evaluates the proposal in terms of the traditional objectives of tax policy, including simplicity, equity, efficiency and stability.

1. The Proposal

(a) Underlying Theory. The EFTS transfer tax is based on one's ability to pay, measured not by net income or consumption, but rather by the degree to which an individual participates in the economy. The theoretical underpinnings for a tax on property transfers are historically well-grounded. As stated by Joseph Pechman, "[i]n societies in which property is privately owned, the state protects the rights of the individual in his property.... Consequently, the state has always regarded property transfers as appropriate objects of taxation."[55] The foregoing justification, of course, normally appears in the context of estate and gift transfer taxes, but the rationale would seem equally persuasive in the case of an EFTS transfer tax. Although the idea of a transfer tax is not new, the EFTS tax is unique insofar as it is designed to penetrate deeply into the fabric of the everyday economy, to co-exist with the lowest possible profile and, most importantly, to raise revenue. Unlike existing estate and gift taxes, the EFTS transfer tax is not intended to advance any overriding social purpose, aside from the traditional objectives of sound tax policy.[56]

(b) The Tax Base. In light of the purpose of the EFTS tax to draw on the most comprehensive tax base possible, the tax would be structured generally to reach "all transfers between accounts effectuated through an electronic fund transfer system." For this purpose and to avoid

[48] *See*, Glines, *Funny Money is No Laughing Matter*, Nation's Business 65 (January, 1983); McGinley, *U.S. Weighs Redesign of Currency To Foil Advances in Counterfeiting*, Wall St. J., June 6, 1984, at 31, col. 3.

[49] *See*, Streeter, *Going After Card Counterfeiters*, ABA Banking J. 53 (August, 1983). Credit card fraud normally takes two forms: card fraud based on lost or stolen cards, and fraud based on illegitimately acquired valid account numbers. Losses in the first category are relatively mild, since owners often report a lost card shortly after the loss. The second category accounts for major losses, since the customer is not aware that the card number has been taken. Generally, merchant collusion and negligence in the disposal of carbon receipts allow criminals to produce counterfeit cards with valid numbers. Losses involved in this category average $500 per card. Counterfeiting has proliferated because of the relative ease of duplication. Last year, police in New York recovered a cache of 200,000 counterfeit Visa, MasterCard and American Express cards, representing a potential loss of about $200 million. The major card companies are investigating various security measures. *Id.* at 53-56. Card holders can minimize losses by tearing up carbon receipts, staying alert during card transactions, being cautious of callers seeking card numbers over the telephone and, for ATM cardholders, not writing PIN numbers on the cards. *See*, Slater, *Credit-Card Holders Can Minimize Losses Due to Fraud by Taking Precautions*, Wall St. J., Feb. 6, 1984, at 23, col. 4.

[50] *See*, Capron & Williams, *supra* note 32, at 406.

[51] *See*, Bequai, *supra* note 38, at 83-93; *USA Today*, June 5, 1984, at 3B, col. 1. (Hand print identification for access to ATM's being tested at Fort Benjamin Harrison, Ind.)

[52] *See*, *Beefing Up the Law*, The Banker 66 (December, 1983). House and Senate Committees are considering legislation that would for the first time make card counterfeiting a federal crime, punishable by maximum fines of $100,000 and 20 years imprisonment. *Id.*

[53] *See*, Bequai, *supra* note 38, at 43-53 for a general discussion of the statutory and common law right of privacy as it relates to development of the cashless society. *See also*, the Privacy Act of 1974, 5 U.S.C. section 552a; Right to Financial Privacy Act of 1978, Pub. L. No. 95-630 (1978). *See generally*, Fink, *Electronic Funds Transfer Systems: Messiah or Pariah*, 47 U.M.K.C. L. Rev. 596, 622-27 (1979).

[54] *See*, Tauber, *supra* note 33, at 324. One commentator estimates that movement to a cashless (and paperless) society would reduce processing costs by 35 percent. *See* Bequai, *supra* note 38, at 8.

[55] *See*, Pechman, Federal Tax Policy 185 (Rev. Ed. 1971).

[56] *See id.*, at 186-87 for a discussion of the underlying social purposes of the estate and gift taxes.

multiple taxation, a single "transfer" would include intermediate transfers in the bank clearing process necessary to move funds from one account to another. A single individual could maintain more than one "account," creating the potential for tax where a person transfers funds, in effect, to himself. The problem can be alleviated somewhat by encouraging the continued development of "universal" accounts offering numerous investment options, debit card access and so forth. This approach seems better than exempting transfers between an individual's wholly owned accounts, since such an approach immediately raises questions regarding the treatment of transfers from a wholly owned account to a joint account, to an account where the individual acts as trustee for another person, and to escrow accounts where the transferor may or may not ultimately recover the funds.

As suggested above, the EFTS tax would provide no exemption or distinction based on the identity of the account owner, nor on the purpose for which the transfer is made. This means, in effect, that religious, charitable and similar organizations presently exempted from the income tax would not be exempted from the EFTS tax. As a preliminary matter, such an approach would not contravene the First Amendment Free Exercise Clause.[57] Uniform taxation of religious organizations, if incident to a broader scheme of taxation, is permissible. In fact, denial of tax exemption for these groups probably advances their long term interests: in an environment of high income tax rates, their exemptions tend to become too precious, providing the IRS with a degree of leverage perhaps unanticipated when such exemptions were originally introduced. A climate of high taxes, coupled with the authority to review tax exemptions has thrust the IRS into the forefront of controversial issues unrelated to the collection of income. As Justice Powell recently observed: "[the IRS's] business is to administer laws designed to produce revenue for the Government, not to promote public policy . . . . It is not appropriate to leave the IRS 'on the cutting edge of developing national policy.' "[58] The denial of tax exemptions under the EFTS tax, while keeping downward pressure on tax rates, will simply sidestep these various social issues, leaving the IRS to perform its primary role of collecting taxes.

Finally, the tax base must be structured to accommodate international transfers. An "international" transfer will be determined by reference to the geographical situs of the accounts. For both inbound and outbound transfers, the EFTS tax will be imposed at the full rate, but there would be a credit of up to one-half the normal rate for any taxes actually paid to a foreign government. The United States EFTS tax would not apply to transfers between two foreign accounts, regardless of the citizenship of the account owner; likewise, the tax would apply to a transfer between two United States accounts owned by foreigners. The reliance on geographical situs as a touchstone for tax jurisdiction is more in conformity with prevailing world attitudes, which have been somewhat irritated by the United States attempt to tax citizens on worldwide income, regardless of their physical residence. Moreover, efforts by U.S. citizens to circumvent EFTS taxation through the use of foreign accounts is perhaps best discouraged by keeping EFTS rates low, thereby minimizing the incentive, and by the development in other nations of similar systems of taxation.

The EFTS transaction tax would be collected automatically at the time of each transfer and remitted immediately to the U.S. Treasury.

(c) Incidence of the Tax. The tax generally would be imposed upon the transferee, unless the parties by agreement shifted the burden to the transferor. The general rule ensures that payments by the government are subject to tax; the exception provides flexibility to accommodate parties' relative bargaining strengths and for situations where the recipient has need of a particular net amount. Incidence of the tax would be shifted to the transferor by having the transferor enter the appropriate direction at the time of transfer, a self-policing feature. The shift would be implemented unless the transferor maintained insufficient funds to pay the tax, in which case the computer would override the command and deduct the tax from the payment.

(d) Tax Rate Schedule. Because of the comprehensiveness of the EFTS transfer tax, the tax rate schedule must be structured to accommodate not only the innumerable daily transactions of consumers, but also the large institutional transfers by banks, corporations, and government. In this regard, a progressive rate structure would impact particularly hard on institutional transfers, as would a strictly proportional tax. For example, a straight 2 percent tax on the purchase of a $10,000 automobile would be $200, a tolerable amount. Yet, on a $50 million short-term loan, the tax would be $1 million, a prohibitive amount. Accordingly, the proposal incorporates a rate schedule based on a proportional tax of 2 percent for the first $50,000, with incrementally reduced rates thereafter. The $50,000 benchmark is large enough to capture nearly all daily transactions (with the exception of major purchases and investments) and the strictly proportional 2 percent rate eliminates "bunching" and other timing concerns under progressive rates.

[57] *See* Simon, *The Tax-Exempt Status of Racially Discriminatory Religious Schools*, 36 Tax L. Rev. 477, 505-06 (1981) where the author concludes: "What little judicial authority there is on that question suggests that the Constitution does not require any tax exemptions for religious organizations . . . . Incidental burdens on free exercise through the use of the taxing power have long been accepted." The Code exempts from income taxation more than just religious organizations. Generally, exemptions fall into two classes. The first group—public service organizations—includes charitable, religious, educational and scientific organizations, private foundations, social welfare organizations, political organizations, cemetery corporations and charitable feeder organizations. The second group—mutual benefit organizations—includes social clubs, fraternal societies, labor unions, trade associations and homeowners' associations. *See* I.R.C. section 501(c); Bittker, *Federal Taxation of Income, Trusts and Estates*, at para. 100.1.1 (1981).

[58] *Bob Jones University v. United States*, 51 U.S.L.W. 4593, 4603 (1983) ("As former IRS Commissioner Kurtz has noted, questions concerning religion and civil rights 'are far afield from the more typical tasks of tax administrators—determining taxable income.' Kurtz, *Difficult Definitional Problems in Tax Administration: Religion and Race*, 23 Catholic Lawyer 301, 301 (1978).") *See, also*, Bittker & Kaufman, *Taxes and Civil Rights: "Constitutionalizing" the Internal Revenue Code*, 82 Yale L.J. 51 (1972).

Amount of Transfer	Tax Rate
up to $50,000	2 percent
$50,000-$100,000	1 percent
$100,000-$150,000	.5 percent
$150,000-$200,000	.25 percent
$200,000-$250,000	.05 percent
over $250,000	.001 percent

Based on the foregoing rate schedule, the purchase of a $10,000 automobile would still be taxed at $200. The $50 million loan, though, would be taxed at the tolerable level of $2,397, an amount often exceeded by professional fees and commissions.

(e) Compliance and Collection. The EFTS transaction tax would be collected automatically at the time of each transfer and remitted immediately to the U.S. Treasury. The self-assessment process, including the various individual, corporate, partnership, trust and estate tax returns under the present income tax system would be eliminated. Auditors would focus their efforts primarily at the network level. Because of the relatively low rate of tax in any one instance, and the elimination of cash from society, taxpayers generally would have neither the motive nor the opportunity to circumvent the tax. For those intent on evading even the EFTS tax, the use of bartering might prove useful.[58] Yet barter tends to be self-limiting since it is inherently inefficient unless conducted through organized exchanges, which are fairly easy to regulate. Moreover, although EFTS' technology could jeopardize one's privacy, compliance efforts would be concerned solely with activity between accounts, not with either the purpose of the transfer or the identity of the account owners. Financial privacy, which has been threatened by the intrusiveness of the income tax, might actually be improved under the EFTS' tax.

The self-assessment process, including the various individual, corporate, partnership, trust and estate tax returns under the present income tax system would be eliminated.

(f) Potential Revenue Effect. It is rather difficult to predict the revenue potential for this EFTS proposal in the absence of econometric testing. In order to provide a rather rough indication of its potential, however, it is assumed for purposes of discussion that the effective average EFTS tax rate would be 1.5 percent and that the tax would succeed in capturing a base equal to the total volume of payments made in the United States, through whatever medium, for 1977. In that year, total payments approached $46 trillion.[59] At an effective rate of 1.5 percent, the EFTS tax would generate $690 billion. If, for the sake of conservatism, the yield is downgraded by 40 percent, then the EFTS tax would still produce about $414 billion, compared to a combined yield in fiscal year 1982-83 for the corporate and individual income taxes of $393 billion.[60] These are rough calculations, of course, and should be refined by further study, although they do at least suggest that the EFTS proposal has substantial revenue potential.

(g) Transitional Considerations. Transition to an EFTS tax involves two primary considerations. First, of course, the proposal hinges entirely on the development of extensive regional, national and, perhaps, international EFTS networks. The private sector has demonstrated a willingness to bear the cost of such development, a process that would be facilitated by a more concerted government effort to promote EFTS networks. In this regard, the financial community probably would receive greater support if it succeeded in identifying EFTS technology with the government's need to raise tax revenues.

Secondly, as EFTS networks are established, their convenience as a medium of exchange, coupled with the gradual recall of denominations of currency larger than $2 bills probably would suffice to channel nearly all meaningful transactions through the EFTS system. At that juncture, the statutory framework for the EFTS tax could be established. A preliminary EFTS tax would be imposed at very low rates, more for purposes of testing and refining the system than for raising revenue. As the preliminary refinements are completed, the Secretary of the Treasury would be vested with statutory authority to increase the EFTS tax over the course of three to five

[58]Other possibilities for avoidance might include the use of foreign currency and "private" currency such as promissory notes as a medium of exchange. Foreign currency, of course, is subject to exchange rate risks and it appears that other advanced nations also are moving rapidly towards the development of EFTS networks and, possibly, cashless societies. Currency of less developed countries is probably too risky to become widely used. With regard to promissory notes, the credit worthiness of the debtor imposes an additional risk and would tend to prevent widespread use. At any rate, the best assurance against avoidance of the EFTS tax is in its low incidence on any particular transaction.

[59]See, Tauber, *supra* note 33, at 324. According to the Federal Reserve Bank of Cleveland, Annual Report for 1977, the values of payments made in the United States in 1976-77 reached the following in billions:

Type	Amount	Percentage
A. Cash	$ 236	9.51
B. Bank Credit:		
Paper Based Message		
Retail Payments	2,106	
Bank Card	33	
Other Card	38	
U.S. Treasury	400	
Business	8,424	
Total Paper	$11,001	23.94
C. Bank Credit:		
Electronic Message		
Retail ACH	3	
Retail POS	0.1	
Treasury ACH	23	
Off-Line Bank Wire	5,100	
Off-Line Fed. Wire	2,040	
CHIPS	9,200	
On-Line Fed. Wire	18,350	
Total Electronic	$34,716.1	75.55
Total Non-Cash	$45,717.1	99.49
Grand Total	$45,953.1	100

[60]See Manvel, *Fiscal Facts and Figures: Tax Collection Trends*, *Tax Notes*, February 6, 1984, p. 532, 533.

years to the target level. Thereafter, the Secretary would be authorized to adjust the rate as necessary pursuant to a predetermined range. As the EFTS tax is increased, the income tax could be reduced, and possibly phased out completely. The result is a rather smooth transition to a new tax system.

2. Evaluation of the Proposed EFTS Transaction Tax

(a) Simplicity. The simplicity of the proposed EFTS tax is a primary advantage over existing income, consumption or value-added taxes. The EFTS tax is easy to understand and easy to pay. The simplicity of the tax and the elimination of the self-assessment process should help to restore harmony between the government and the taxpayers, who have been pushed to the verge of revolt under the income tax.[62]

(b) Equity. As noted earlier, tax equity requires, first, that similarly-situated taxpayers be taxed alike (horizontal equity) and, second, that taxpayers in different economic circumstances be taxed differently (vertical equity). In terms of horizontal equity, the comprehensiveness of the EFTS tax base and the absence of definitional distinctions among taxpayers suggests that similarly-situated taxpayers—those exercising equal amounts of resources—are taxed equally. For example, both mortgage payments and rent payments are equally taxed, removing the bias against tenants under the current tax system. Moreover, with little or no cash in circulation, there would be virtually no underground economy, ensuring that similarly-situated taxpayers do, in fact, contribute their fair share.

Financial privacy, which has been threatened by the intrusiveness of the income tax, might actually be improved under the EFTS tax.

In the business sector, a capital intensive firm would pay the same tax on a purchase of equipment that a service firm pays on a commensurate amount of payroll. The roughly proportional tax rate and the "pay-as-you-go" approach inherent in the EFTS tax eliminates many of the timing considerations which are so important under the present system. For manufacturers, the EFTS tax does have the potential to pyramid, with the final purchase price of a product reflecting the tax burden accumulated at each step in the flow of goods. In this respect, the EFTS tax is remotely similar to the value-added tax. If tax accumulations become overly burdensome (which seems unlikely, given the low rate) and certain businesses are not able to avoid such effects through vertical integration of operations, then methods of relief extraneous to the tax system, such as direct cash subsidies, might be justified. Direct subsidies, of course, involve difficult "above board" political choices which are likely to discourage their use. In any event, as this country continues its shift toward a service economy, incidences of pyramiding are likely to diminish.

A capital intensive firm would pay the same tax on a purchase of equipment that a service firm pays on a commensurate amount of payroll.

With regard to vertical equity, the proposed tax rate schedule theoretically is regressive. In practice, however, the $50,000 threshhold on the 2 percent rate provides proportional treatment for the overwhelming number of transactions at the non-institutional level. The reduced rate brackets are likely to be used primarily by institutions and are necessary to prevent the tax from becoming an undue burden on commerce. When the comprehensiveness of the EFTS tax is considered, it is likely to prove progressive in its application to wealthier individuals when compared to the effects of the present income tax system. This consequence is attributable to the lack of incentive and the inability of wealthier individuals to engage in effective EFTS tax planning, and because the tax encompasses the exercise of economic power, something not always subject to the income tax.[63]

With regard to its impact on poorer segments of the population, the EFTS tax produces some regressive effects, insofar as it will tax certain individuals not currently subject to the income tax. Some of these individuals, no doubt, are participants in the underground economy and would be subject to income tax if discovered. Others, of course, are in different circumstances and the EFTS tax will impose an additional burden. Nevertheless, the total dollar effect of the tax is likely to be rather slight (between $200-$400 on $10,000 of economic activity), and could be factored into extraneous forms of relief provided through food stamps, AFDC and other welfare programs. Data derived from the EFTS system will enable welfare officials to review economic activity by those receiving welfare payments, improving responsiveness to their needs.[64]

Concededly, the EFTS tax does not attempt theoretical perfection and, perhaps because of that, it is likely to achieve a tolerable measure of fairness. The low rate of the tax is the best prevention against inequity in any particular instance, and if inequities requiring attention do surface, they still can be remedied through programs extraneous to the tax system.

[62] In addition, the EFTS tax will help restore discipline in Congress. One by-product of the EFTS tax is the elimination of the multi-billion dollar tax expenditure budget under the income tax. For a discussion of the disintegration of the legislative process precipitating these enormous tax preferences, *see* Surrey, *Our Troubled Tax Policy: False Routes and Proper Paths to Change*, *Tax Notes*, Special Report Supplement (1981), p. 9.

[63] See Surrey, *supra* note 62, at 4.

[64] In 1981, there were reported 574,130 robberies in the United States. *See*, *Report to the Nation on Crime and Justice*, U.S. Department of Justice 7 (October, 1983). The Report concludes that, "Blacks are more likely to be victims of violent crime than whites or members of other racial groups. . . . Violent crime rates are higher for lower income people." *Id.* at 19. To the extent robbery is reduced by the cashless society, quality of life will be improved for this group, clearly a progressive feature.

(c) Efficiency. A tax is efficient if it is a neutral consideration in the allocation of resources. A secondary concern is with its effectiveness as a revenue raiser. With regard to neutrality, the EFTS tax probably will have little impact on the allocation of resources. The tax rate is sufficiently low to minimize its influence on any single decision and its application sufficiently comprehensive and certain to limit attempts to avoid the tax. The tax will, however, place a small premium on streamlining payment channels. For example, if father intends to pay son's college tuition, it would be less costly for father to pay the college directly, rather than indirectly through the son's account.

When the comprehensiveness of the EFTS tax is considered, it is likely to prove progressive in its application to wealthier individuals when compared to the effects of the present income tax system.

Moreover, as indicated in the previous section, the EFTS tax is likely to pyramid in multi-party manufacturing processes. To the extent the tax becomes burdensome, it will provide an incentive for firms to integrate vertically. However, the accumulation of tax is not likely to be serious, in light of the low 2 percent rate. In any event, if the need for relief is compelling then, as mentioned earlier, direct cash subsidies could be provided and closely monitored.

With regard to the effectiveness of the EFTS tax to raise revenue, perhaps its principal advantage is that it will operate virtually in a cashless environment, eliminating the underground economy which continually has plagued the effectiveness of the income tax. The breadth of the tax base allows the tax to permeate the economic process, ensuring a smooth flow of revenue. The nature of the EFT system will allow automatic collection of the tax and immediate remittance to the Treasury. The effectiveness of the tax will produce savings in other areas of government. For example, court dockets now encumbered by numerous tax protester cases and other tax-related litigation would be relieved substantially.[65] In addition, both taxpayers and the IRS are likely to benefit from a simpler system which does not rely on the expense, inconvenience and frustration of "self-assessment."[66]

(d) Stability. A final objective of tax policy is in the ability of a particular tax to stabilize fluctuations in the economy, either automatically through the rate structure, or through its responsiveness to changes in government policy. In this regard, the proportional nature of the EFTS tax is not likely to provide inherent stability since tax burdens will change only in direct proportion to one's ability to pay. Yet, the present income tax is roughly proportional (and sometimes regressive) in its actual operation, so the lack of true progressivity in the EFTS rate schedule is not likely to impose a disadvantage not already encountered under the income tax.

In terms of the responsiveness of the tax to changes in government policy, the EFTS tax is likely to provide a significant advantage over the income tax. The responsiveness of monetary machinery to changes in government policy is attributable to the control exercised by the Federal Reserve Board over bank reserves. Likewise, the EFTS tax would be used as a subtle tool of fiscal control by vesting in the Secretary of the Treasury statutory discretion to adjust the rate schedule uniformly across a predetermined range. Adjustments in response to Treasury policy could be accomplished quickly with minor editing of the EFTS collection programs. The result would be a system providing a new opportunity to coordinate more closely the country's fiscal and monetary policy.

The EFTS tax is likely to pyramid in multi-party manufacturing processes . . . and to the extent the tax becomes burdensome, it will provide an incentive for firms to integrate vertically.

CONCLUSION

Since the age of Caesar, governments have strived to create a truly simple, fair and efficient method of raising revenue. As we move out of the industrial revolution and into a post-industrial technological society, opportunities for tax reform never before encountered will emerge. The proposal for an EFTS transaction tax is not an overnight solution; it presupposes a comprehensive EFTS network, something which will still take a number of years to complete. During the interim, however, it seems worthwhile to begin formulating tax policy to take advantage of these technological advancements as they become available. In this regard, it is hoped that this proposal will stimulate interest in the possibilities for tax reform in a post-industrial America.

[65]Between 1973 and 1981, the number of tax protester returns increased from nearly 7,000 to over 21,000. *See, Tax Protesters: Dollar Theory vs. the IRS, Tax Notes*, August 23, 1982, p. 771. *See also, Grimes v. Commissioner*, No. 744-83 (U.S.T.C. 2/6/84) where Judge Fay imposed a $2,500 damage award against a tax protester under section 6673 for repeatedly filing frivolous cases. The judge remarked that, "this Court [has] continued to be inundated with an ever increasing number of 'tax protester' cases." In order to alleviate the problem, Congress is considering a proposal to grant amnesty to tax cheats. A similar proposal netted Massachusetts over $40 million in back taxes. *See, Tax Notes*, January 30, 1984, p. 352.

[66]Currently, over 40 percent of taxpayers require professional assistance in tax return preparation, at a cost of over $1 billion. *See, supra* note 13.